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Edmund F. Ingalls

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PRACTICAL ACCOUNTING AND AUDITING PROBLEMS

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PRACTICAL ACCOUNTING AND AUDITING PROBLEMS

BY EDMUND F. INGALLS

Practical Accounting and Auditing Problems

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A GUIDEBOOK FOR THE PROFESSION

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VOLUME 2

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Dividends and Distributions

DIVIDENDS DECLARED OR PAID

Inquiry 339

Accounting for: (1) Stock issuance expenses, and (2) dividends, where declaration date prior, but record date subsequent, to fiscal year-end

"The following problems are submitted for your consideration and possible discussion:

"1. Should the cost of issuing (certificates, transfer agent, mailing, etc.) a stock dividend be expensed or charged against paid-in surplus (capital surplus)?

"2. If a cash dividend is declared in one fiscal year, payable to stockholders of record in the next fiscal year, actual payment made subsequent to the record date, and stock options are outstanding, should the liability and reduction of earned surplus be recorded in the year of declaration, or should the above situation be disclosed by a footnote only? If the liability and surplus reduction should be recorded in the year of declaration, what amount should be used, since it is possible that the number of shares outstanding may increase as a result of stock options exercised subsequent to the year-end and prior to the record date?"

Our Opinion

1. In our opinion, expenditures made in connection with the issuance of a stock dividend should be charged against any paid-in surplus arising as a result of such issuance (as in a case where an amount of earned surplus in excess of the aggregate par or stated value of the dividend shares is capitalized); or against any paid-in surplus attributable to the class of stock issue involved or against any paid-in surplus attributable to a class or issue of stock no longer outstanding; and any remaining balance should be charged against earned surplus.

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, at pp. 384-5) deals with the general question of "Expenses of Stock Issues," as follows:

> Underwriting discounts, professional fees and related expenses are properly considered a reduction of the proceeds of a stock issue before determining the amount to be capitalized. These expenses include commissions to selling agents; attorneys', engineers', or accountants' fees; printing costs; SEC filing fees; and other expenses clearly and directly attributable to realization of proceeds of the shares issued. If the offering price is at least par value but expenses of issue bring the net proceeds below par or stated value, the stock should be shown at par and the difference charged first to any available paid-in surplus on issues no longer outstanding, and the balance against earned surplus.[1]

2. In our opinion, assuming that there is no evidence of an intent to contract (i.e., to reduce) the number of outstanding shares prior

[1] It is of interest to note in this connection that section 507 of the *New York Business Corporation Law*, which became effective September 1, 1963, explicitly provides that "Reasonable expenses of organization or reorganization or reasonable expenses of and compensation for the sale or underwriting of shares may be paid or allowed out of the consideration received for such shares without impairing their fully paid status."

to record date, the liability for the dividend should be set up and earned surplus should be capitalized based on the shares outstanding at the end of the fiscal year of declaration. Reference should then be made in a footnote to the financial statements, to the fact that the company has a liability for possible additional cash dividends *contingent* upon the extent to which outstanding stock options are exercised prior to the record date.[2]

Inquiry **340**

Cash payments to stockholders despite absence of earnings, earned surplus, or capital surplus — balance-sheet presentation

"I am writing you regarding an accounting problem that has existed with one of my clients for several years. I am sure that the following has arisen in other cases, but I have been unable to discover any literature covering the exact situation, although page 339 of *Practical Applications of Accounting Standards,* by Carman G. Blough (AICPA, 1957) lends some assistance.

"The corporation under consideration is one organized to hold title and rent an apartment building. Several years ago, incorporators all sold their stock for consideration far in excess of the par and paid-in value appearing on the balance sheet of the corporation.

"For the past several years, as a result of depreciation expense being greater than the principal mortgage payments, the available cash for dividends has been far in excess of net profits, and there was no previous accumulation of earned surplus. The directors and stockholders have consistently paid themselves an amount equivalent to the cash available, and earned surplus was charged with the portion of these distributions equal to earnings. At this date the earned surplus account is zero, and there is no capital surplus.

[2] For its relevance to the question raised, i.e., another case involving intervention of fiscal year-end between declaration and record dates, see the item entitled "Recording a Stock Dividend" which appeared in Carman G. Blough's column at pp. 84-5 of the July, 1949 issue of *The Journal of Accountancy.*

"My question is: How should the payments to the stockholders in excess of earnings be shown on the corporation's balance sheet? I might say that the tax effects to the individual stockholders present no problems since proceeds are ordinary income to the extent of earnings and a return of capital for the balance. After the investments have been recovered, receipts in excess of earnings will be reported as a capital gain.

"I would like to mention the accounting treatment which we have used in past years. Payments to stockholders in excess of earnings have been shown as 'Loans Receivable – Stockholders.' The balance in this account has grown quite large, and the stockholders become alarmed each time they see a balance sheet. These loans will never be repaid, and the question is often raised as to whether stock is transferred subject to the obligation of the transferor.

"Independent appraisers agree that the building is subject to reappraisal on the books of the corporation. Of course, we do not consider it a good accounting principle to reflect such appraisals, but I am wondering if a reappraisal surplus could not be used to absorb the charge for these payments to the stockholders in excess of earnings."

Our Opinion

You ask how the payments to stockholders in excess of earnings should be shown on the corporation's balance sheet. In our opinion, the item "Loans Receivable – Stockholders" should be reclassified and eliminated by transferring the balance to a deficit account. On the balance sheet, we believe the balance in question should be designated as "Cash Payments to Stockholders (or Dividends, or Distributions) in Excess of Accumulated Earnings," or as "Deficit – Arising from Distributions in Excess of Accumulated Earnings," and shown as a deduction from the "Capital Stock – Issued and Outstanding." Note that the foregoing corresponds generally with the suggested presentation in the second paragraph on p. 338 and last paragraph beginning thereon in Carman G. Blough's book *Practical Applications of Accounting Standards* (AICPA, 1957).

In suggesting elimination of the "Loans Receivable – Stockholders" account, we assume that board resolutions covering the several distributions of "available" cash did not specify that amounts in excess of reported earnings represent *loans* made to stockholders.

Furthermore, just as "Stock Subscriptions Receivable" should be shown as a deduction from capital if there is no real intention to call for payment thereof, so also should the "loans" in question be shown as a deduction from capital if they "will never be repaid." It goes without saying it is improper to reflect receivables on a balance sheet unless they are realizable.

One might presume that the "Loans Receivable — Stockholders" account was set up in the first instance on the theory that the excess distributions represented illegal dividends, and consequently, the corporation or present or possible judgment-creditors had an available cause of action against the stockholders to get restitution of the excess payments. Even indulging such presumption, it seems to us it would be erroneous accounting-wise to set the claims up as receivables prior to the actual bringing of a suit or prior to the time when a suit brought resulted in the judgment sought.

There is a basic legal question here, it seems to us, whether the excess payments represent illegal dividends. An intimately related legal question is whether, under the statutes and judicial interpretations of the state of incorporation, cash dividend payments may be based on unrealized (and unrecorded) appreciation. We are in no position to attempt to answer such questions. However, determination of the legal effect of the excess payments is highly relevant, we believe, when considering the ultimate disposition of the deficit.

The balance sheet, under the treatment recommended above, would reflect a capital impairment. It may be legally permissible in the state of incorporation to reduce the par or stated value of the corporation's stock thereby creating a reduction surplus which may then be used retroactively to absorb the deficit, on the ground that the excess payments were dividends in partial liquidation.

Regarding the propriety from an *accounting* standpoint, of setting up an appraisal surplus on the books of the corporation, it seems to us an upward restatement is warranted, if at all, only when the higher values can be clearly and objectively demonstrated by reasonably expected earning power based on historical earnings *and taking into account additional charges which would arise (depreciation on appreciation)* as a result of reflecting higher asset values. If the burden of the foregoing criterion can be met and appraisal surplus is recognized, such surplus, we believe, may then be used to absorb the deficit due to excess payments. Of course, in determining the valuations to be reflected in the accounts to accomplish an upward restatement, the unavailability of income tax deductions in relation to the proposed higher carrying values should be given appropriate recognition [see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at top of p. 500].

Regarding the permissibility from a *legal* standpoint, of setting up an appraisal surplus on the books of the corporation, and then charging the deficit thereagainst, it seems to us one would be well-advised to get a legal opinion on whether the law in the state of incorporation should be or is construed as proscribing *cash* dividends out of appraisal surplus. As you may know, some state corporation statutes expressly permit *only* the payment of *stock* dividends out of net assets in excess of the par value of a corporation's stock, as determined by competent independent appraisal of tangible assets. Query whether, after setting up an appraisal surplus and "permanently capitalizing" same by issuing a stock dividend under one section, the corporation may later reduce its capital and create a reduction surplus under another section; or would this procedure be estopped?

Another question which should be considered is whether the corporation's property may have been grossly overdepreciated and whether adjustment of the depreciation reserve would create sufficient earned surplus to offset the deficit (see fifth complete paragraph, p. 395, of *Montgomery's Auditing, op. cit. supra*).

Inquiry **341**

Dividends in excess of retained earnings

"We were very much interested in the discussion of dividends in excess of retained earnings in the 'Accounting and Auditing Problems' section of the November, 1958 issue of *The Journal of Accountancy.*

"We would appreciate your comments as to the accounting and tax status of these distributions to the stockholders both currently and upon sale or liquidation of the corporation based on the following:

1. The distributions are not intended to be loans.
2. The capital stock account has been charged for prior year distributions and is now down to zero."

Our Opinion

As a matter of Institute policy, we do not undertake to answer tax questions.

However, see the correspondence *directly following*, regarding the propriety or impropriety of the procedure of charging distributions in excess of retained earnings to the accumulated allowance for depreciation.

Anent statements "1" and "2" in your letter, there is little question in our mind as to the accounting status of the "Distributions to Stockholders in Excess of Accumulated Earnings" – assuming that the accounts have consistently been maintained in accordance with generally accepted accounting principles, such accumulated distributions measure the extent to which the stated capital of the corporation is impaired. However, there is a correlative question here whether the distributions constitute illegal dividends. Opinion of counsel on this matter should be obtained. It is our understanding that "New York is unique in employing impairment of capital as the sole criterion" of whether dividend payments are legal or illegal.[1]

Of course, the fact that distributions are or are not intended to be loans becomes more or less academic in the circumstances of the case, if judgment-creditors of the corporation at any stage proved unlawful dividends and a court compelled the stockholders to make restitution to the corporation.

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1 See "Dividends – Changing Patterns," by A. M. Kreidmann (in 57 *Columbia Law Review* 372 at p. 375; but see also, at pp. 379-81 of same article, the discussion of Randall v. Bailey). Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954) at pp. 528 and 546-7 also contains pertinent discussion.

Inquiry 342

Charging dividends to accumulated allowance for depreciation, in absence of earned surplus

"The November, 1958 issue of *The Journal of Accountancy* related a situation in the column 'Accounting and Auditing Problems,' titled 'A Case of Dividends in Excess of Retained Earnings.'

"The writer described a situation whereby, as a result of depreciation expense being greater than the payments on the mortgage, a corporation which held title to a piece of rental property had not accumulated earned surplus. There had been, nevertheless, an accumulation of cash in the corporation which, from time to time, had been distributed to the stockholders as 'Loans Receivable — Stockholders.' The writer inquired as to whether or not this was an appropriate way in which to handle the distribution of cash.

"In this same article, a reply was given which recommended that the distribution be shown as a deduction from the amount of capital stock issued and outstanding, with an appropriate title such as 'Distribution to Stockholders in Excess of Accumulated Earnings.'

"I submit herewith an alternative approach which I have used in connection with large rental housing projects. As a result of using accelerated depreciation, my client has also accumulated cash in excess of normal operating requirements. On the assumption that the absence of earned surplus was a direct result of using an accelerated depreciation which is in excess of the mortgage amortization, I have recommended that the client charge such a distribution of cash to stockholders against the accumulated reserve for depreciation. This method of handling such distributions is likewise recognized for tax purposes; Internal Revenue Reg. 1.316-2(e) recognizes that such distributions from the depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. Once the distribution reduces the basis of the stock to zero, any excess would be taxable to the recipient stockholder as a capital gain. No distribution, however, can be made from such a reserve until all the earnings and profits of the corporation have first been distributed.

"I believe that there is justifiable reason for charging such a distribution to the reserve for depreciation, for such distributions do not, in reality, diminish the net worth of the corporation. In this situation, I have always made adequate disclosure of the facts in the manner of a suitable notation to the financial statement."

Our Opinion

Unless one had a factual basis for concluding that the depreciation reserve contains excessive accumulations of depreciation and *unless* the distributions were in fact made only to the extent of such excessive accumulations, we believe the alternative procedure described in your letter is misleading, if not improper. Of course, if it were clear in a given case that materially excessive accumulations of depreciation *are* included in the reserve, one might reasonably contend that the excessive accumulations represent "hidden" reserves which more properly should lodge in earned surplus.

In our opinion, your assertion that "such distributions do not, in reality, diminish the net worth of the corporation," is untenable. It seems to us that any distribution or severance of assets from a corporation which is not accompanied by the acquisition of equivalent assets or the proper reduction of a liability, reduces net assets. Even if distributions are made out of "hidden reserves" in the form of exorbitant valuation reserves, excessive depreciation allowance accounts, or overstated estimated liability accounts, such distributions (to the extent that the reserve or account is excessive) reduce the net worth that would otherwise have been reflected if generally accepted accounting principles had been followed at the outset. In the instant case, charging the distributions to the depreciation reserve circumvents reflecting a capital impairment in the balance sheet; by the same token, we believe it misrepresents or "waters" the capital.

The heart of this question, it appears, is whether depreciation accounting is a valid principle or procedure, and depreciation a valid cost, in the determination of periodic income. The Institute's Committee on Accounting Procedure has stated (in *Accounting Research Bulletin No. 44,* Revised, 1958) that the declining-balance method of depreciation "meets the requirements of being 'systematic and rational' "; the clear inference is that it is a generally accepted method of allocating cost. Accordingly, once the declining-balance method is employed in good faith, and assuming the rate used is based on a realistic estimate of useful life, and assuming further, that we are dealing with a "going concern," then it appears that one is estopped on the ground of inconsistency from reducing the accumulated depreciation in order to effect a distribution of corporate assets. Accounting is "utilitarian," but it should not be made into a vehicle of expediency.

In the case in question, unless there is continuous expansion of the operation, it is likely that high depreciation charges or deductions and low or no taxes in the early years will be followed by low or nominal depreciation charges and high taxes in the later years.

Incidentally, the fact that Internal Revenue Reg. 1.316-2(e) specifies the tax treatment to be accorded distributions out of depreciation reserves is no warrant for concluding that the Internal Revenue Service justifies such distributions or is thereby indicating that it deems them proper or improper. However, the fact that the regulation provides that the distributions in question be applied to reduce the bases of the stock of the recipients, strongly suggests that the IRS views the transaction fundamentally as a return of capital. A corollary of this view would be that the distribution, no matter where charged on the distributing corporation's books, represents a liquidating distribution out of its capital.

Inquiry 343

Propriety of distributions out of capital surplus, when earned surplus is available

"We would appreciate any assistance or suggestions you can offer us with respect to the following matter:

"Corporation in question reflects the following stockholders' equity on its books:

Convertible Preferred Stock – Par $10	$1,000,000
Common Stock – Par 50¢	600,000
Capital Surplus	4,500,000
Earned Surplus	1,000,000

"The preferred and common shares are publicly-held.

"It is expected that within a short period of time the outstanding preferred stock will be converted into common stock and that any remaining unconverted shares will be called for redemption by the company. Upon this conversion, the capital surplus will be further greatly increased from its present amount.

"The present capital-surplus balance was largely created from preferred stock conversions into common stock during the past several years.

"Because of the need to preserve working capital for expansion, the company has regularly paid modest cash dividends and stock dividends and also had a stock split within recent years. The periodic stock dividends have caused a substantial transfer from earned surplus to capital surplus by reason of charging earned surplus with the approximate market value of the stock dividends.

"The question is: Can the company make some distributions to stockholders or some other type of capital adjustments, whereby the transaction could properly be charged to the capital surplus account and not further deplete the earned surplus?"

Our Opinion

The question you raise whether the company may properly make distributions to stockholders out of capital surplus arising in the manner described in your letter, is basically a legal problem which we are not in a position to answer. The statutes and judicial decisions of the state of incorporation control this matter. The decision to use the capital surplus as a source of dividend payments or distributions may also be affected by SEC and stock exchange regulations – not to mention Federal tax considerations.

How is "stated or legal capital" defined in the state of incorporation? Is *all* earned surplus capitalized in connection with the issuance of a stock dividend deemed to be "stated capital" under the state law, even though a portion thereof may be classified in the balance sheet as capital surplus? [See par. 10, p. 51 of *Accounting Research Bulletin No. 43* (AICPA, 1953) and the usage of the term "permanent capitalization," therein; see also Hills, *op.cit.* in footnote, second par., p. 152.] Is the "earned surplus" test, the "insolvency" test, or some other standard used in the state of incorporation, in determining the legal availability of surplus for payment of a dividend? Since the portion of the capital-surplus balance arising from preferred stock conversions may be regarded as a species of so-called "reduction surplus," does the corporate law of the state have anything to say respecting the payment of dividends therefrom? May a dividend properly be declared in cash (property) (stock) out of capital surplus? In the presence of earned surplus? Assuming the capital surplus in question or a portion thereof is legally deemed to be part of "stated capital," what then are the procedures to be employed in effecting a reduction of capital or in making a distribution in partial liquidation? It seems to us these are some of the key legal questions to be decided before making any distributions out of the capital surplus in question.

There are also the tax questions whether a distribution will be deemed to be made first out of earned surplus ("earnings and profits"), etc., regardless of the fact that an accounting charge has been made to capital surplus, and whether earned surplus capitalized pursuant to a stock dividend remains a part of "earnings and profits."

In our opinion, one of the principal responsibilities of the accountant is to see that adequate disclosure of the source of the dividend payment or distribution is made in the financial statements if such payment or distribution is made out of surplus other than earned surplus. In this connection, see the discussion of the SEC's restrictive policy on dividends out of paid-in surplus at the bottom of p. 414 and top of p. 415 in the 1949 edition of *Montgomery's Auditing*.[1]

Certain sections of the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with American Bar Association) may be of interest. The *Act* has been substantially or partially enacted in a number of states. While the *Act* may not be controlling in the particular state of incorporation in question here, nevertheless because of its sponsorship by the American Law Institute and American Bar Association, it may be regarded as a sound guide to good corporate practice in the absence of any clear rulings on the matter of distributions out of capital surplus in the state of incorporation. Note that the *Model Act* allows *stock* dividends to be paid out of *any* surplus, subject to certain conditions (section 40), and also

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[1] For other helpful references on this matter, see:

1. "Dividends – Changing Patterns," by A. M. Kreidmann (in 57 *Columbia Law Review*, at pp. 372-85).
2. Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957), chapter 4 on "Proprietorship."
3. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957 edition) at pp. 396 (middle); 407 (top); 408 (top); 417 (bottom); and 430.

provides for distributions in partial liquidation out of either capital or capital surplus, subject to certain conditions (section 41).

Incidentally, we called the Department of Stock List of the New York Stock Exchange to determine whether they had any ruling on, or policy regarding, payment of dividends out of capital surplus in the presence of available earned surplus. We asked specifically whether they would countenance dividends being charged to capital surplus arising from capitalization of earned surplus in connection with stock dividends. The person with whom we talked stated only that the case had not as yet presented itself, and that if the case did come up, the Exchange would scrutinize the situation closely to determine whether it had a "valid business purpose" or reason.

Inquiry **344**

Regular cash dividends paid out of capital surplus, although earned surplus available

"We have a corporate client who wishes to charge future payments of regular cash dividends to capital surplus although there is earned surplus available for such charges.

"The capital surplus which the client wishes to charge arose as a result of the difference between par and market value of capital stock issued to purchase the operating assets of another corporation.

"The client intends to notify its stockholders (approximately one thousand) that the dividend is being paid from capital surplus. It has also secured an opinion from its counsel that such surplus is legally available for dividends in this state.

"We would be most grateful for any reference material you may have on this subject along with your opinion as to the propriety of such a charge to capital surplus."

Our Opinion

It seems to us the following passage from Finney and Miller's *Principles of Accounting – Intermediate* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958, at p. 138) is relevant to the question you raise:

> A good many writers on accounting have said that dividends should be paid from earned surplus only. If they mean that dividends from other sources are illegal, the statement is subject to contradiction; if an action is permitted by law, accountants can interpose no effective "should not" deterrent. However, since it is quite possible that stockholders may be uninformed as to the law and may assume that all dividends received represent distributions of retained earnings, the ethics of business management may properly require that, if a dividend is paid from any source other than retained earnings, the stockholders be informed of the source.

In our opinion, Finney and Miller have stated the case with perspective.

Our feeling is that although it is admittedly unusual to charge regular cash dividends to capital surplus when earned surplus is otherwise available, the CPA should not interpose an objection to the procedure *provided that* there is no legal deterrent and *provided also that* stockholders are informed of the source from which the dividend is paid.

If the procedure is continued for any appreciable period of time and the cumulative distributions are material, it may also be advisable to inform the stockholders as to the effect of such distributions on "earnings and profits" for tax purposes. In other words, if the distributions charged to capital surplus are taxable to the recipients as ordinary income and serve to reduce "earnings and profits" for tax purposes, the corporation may arrive at the stage where a material portion of its book earned surplus will not be subject to ordinary income treatment when distributed since it is not deemed to be part of the "earnings and profits" base.

It is of interest to note that the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with American Bar Association) which has been enacted substantially by several states, provides (section 40) that "Dividends may be declared and paid in cash or property *only out of* the unreserved and unrestricted *earned surplus* of the corporation . . ." (*our emphasis*). However, the *Act* (section 41) also provides for "Distributions in Partial Liquidation" out of stated capital or capital surplus, but such distributions are subject to several conditions.[1]

Inquiry **345**

A. Distributions by subsidiaries from acquisition and paid-in surplus exceeding parent's operating loss — does excess constitute proper dividend base for parent?

B. Equity method of accounting for investment in subsidiary

"My client is a parent corporation whose stock is publicly-held, and which has three wholly-owned subsidiaries. One subsidiary had substantial earned surplus which originated prior to acquisition by the parent corporation, which has been paid to the parent as a dividend. Another subsidiary is incorporated in the state of .... and, although it had no earnings, it has paid dividends to the parent out of its paid-in surplus. (Parent's counsel advises that this is legal under said state's statutes.)

"The amount of these dividends received by the parent from its subsidiaries (a portion out of one subsidiary's surplus earned prior to acquisition, and the remainder out of another subsidiary's paid-in surplus) exceeded the operating loss sustained by the parent. Out of this excess, the parent paid dividends to its some 300 stockholders. (Parent's counsel advises that this is also legal.)

"Under proper accounting, these dividends received by the parent from its subsidiaries cannot become part of the parent's earned surplus, nor, in consolidation, can they be included in consolidated earned surplus. Handling these dividends from subsidiaries in this manner will, of course, result in an earned surplus deficit for the parent as well as a deficit in consolidated earned surplus.

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[1] For additional background on this question, see pp. 156-65 in Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957); pp. 396, 407, 417, 430, and 439 in *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957); pp. 310-12 in Rappaport's *SEC Accounting Practice and Procedure* (Ronald Press Co., N.Y., 1959); and pp. 377 and 382 in the article "Dividends – Changing Patterns," by A. M. Kreidmann (in 57 *Columbia Law Review* 372).

"My problem then is this: Is it proper to charge the dividends paid by the parent to its stockholders against the parent's earned surplus, thus increasing its deficit? The same problem exists with respect to consolidated earned surplus.

"The parent has substantial paid-in surplus resulting from assets it received in exchange for its stock having a value in excess of the par value of such stock. The truth of the matter is that the parent had no earned surplus with which to pay dividends, nor, in consolidation, is there any consolidated earned surplus. However, the fact remains that dividends were paid by the parent. If, under proper accounting, there was no earned surplus, then it seems logical to me that the only place such dividends could have been paid from was paid-in surplus and, therefore, such dividends should be charged against paid-in surplus.

"For the sake of assurance that this problem has been presented clearly, I give the following illustrative figures:

	Funds Considered by Counsel to be Available for Dividends	*Consolidated Earned Surplus or (Deficit)*	*Consolidated Paid-In Surplus*
Beginning Balance	$4,000	$(3,000)	$300,000
Transactions:			
Net Operating Loss for Period	(10,000)	(10,000)	–
Dividend Received from Subsidiary Out of Its Surplus Earned Prior to Acquisition	15,000	–	–
Dividend Received from Other Subsidiary Out of Its Paid-In Surplus	10,000	–	–
Balance before Dividends Paid by Parent	19,000	(13,000)	300,000
Dividend Paid by Parent	(18,000)	(18,000)	(18,000)
Ending Balance	$ 1,000	or $(31,000)	or $282,000

"In addition to your views on the problem outlined above, I would like to know whether the Institute has a preference as to the cost or equity method of carrying a parent's investment in its subsidiaries.

INQUIRY: 345

The equity method is, to me, the most desirable. However, I am sure that my client will insist upon the cost method in the event that I have a choice in the matter."

Our Opinion

Regarding the specific question raised in the fourth paragraph of your letter, we believe there is some difference of opinion among accountants as to whether distributions made or dividends paid by a corporation at the time of an existing operating deficit, should be charged to its earned surplus (deficit) account or to its capital or paid-in surplus account.[1] You will note that the third-listed item in footnote 1 went along with the practice of charging the dividends to the earned surplus (deficit) account provided disclosure is made of the fact that the reported deficit is composed of dividend payments of specified amounts. The reasoning was that if the dividends were directly charged to capital surplus and only the balance of capital surplus shown in the balance sheet, "both the amount of the contributed capital and the extent to which it has been impaired would be understated." However, you will also note that the fourth-listed item in footnote 1 suggested use of a caption, "Distributions to Stockholders in Excess of Accumulated Earnings" to be deducted from the corporation's "Capital Stock – issued and outstanding" account in the balance sheet (in the absence of any paid-in surplus); the fifth-listed item in footnote 1 recognizes the propriety of charging a dividend to paid-in surplus in the presence of an earned surplus if the board of directors specifies paid-in surplus as the source of the dividend payment, if there is no legal impediment thereto, and if proper notice of

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[1] In this connection, see the following items which appeared in Carman G. Blough's column at the indicated page and issue of *The Journal of Accountancy*:

1. "Paying Dividends During Deficit Period" (p. 425, May, 1947).
2. "Creating Earned Surplus" (p. 157, February, 1947).
3. "Dividend Payments Despite Existence of Operating Deficit" (pp. 257-9, March, 1948).
4. "A Case of Dividends in Excess of Retained Earnings" (p. 73, November, 1958).
5. "Dividends Not Necessarily Charged to Earned Surplus" (pp. 69-70, October, 1959).

the source from which the dividend is paid, is given to stockholders.[2]

In our opinion, the first- and third-listed items in footnote 2, as well as rule 3, p. 11, of *Accounting Research Bulletin No. 43* (AICPA, 1953) definitely support the conclusion expressed in the third paragraph of your letter as to the proper accounting treatment to be accorded the dividends received by the parent from its subsidiaries. The fact that the dividends declared and paid by the subsidiaries are *legal* dividends (as advised by the client's counsel), is not by itself determinative of the accounting treatment to be accorded such dividends by the parent recipient. The *source* of the dividend distributions by the subsidiaries does or may well control the question as to whether the recipient should account for the dividends as income or as return of capital.

Assuming that the paid-in surplus of the parent company was properly recorded (i.e., that the value assigned to the assets received for its stock was supportable in the first instance), then it appears the parent company does presently have a *dividend base* from a legal standpoint, but only to the extent its paid-in surplus is unimpaired. In our opinion, the distributions from the subsidiaries represent return of capital in the hands of the parent company; do not represent income, and accordingly, should not lodge in the parent company's earned surplus (deficit) account; and form no part of the parent company's dividend base.[3]

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[2] You will also find relevant material in the following references, viz.:

1. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) pp. 407-09, 430, 438-9, and 490-2.
2. *The Law of Accounting and Financial Statements,* by G. S. Hills (Little, Brown & Co., Boston, 1957) pp. 38-9, 153-65.
3. *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) at pp. 5.26, 13.15-17, 21.1-2, 22.23-4, 22.28, 22.30-4, and 23.10-14.
4. *Model Business Corporation Act,* section 40 and esp. 41 as revised, 1953 (published by American Law Institute in collaboration with the American Bar Association).

[3] NOTE: Query whether *differing* treatments of the distributions out of paid-in surplus may be supported, depending on the *original source* of the paid-in surplus? Thus, if the subsidiary's paid-in surplus represents capital contributed (or paid for at acquisition) by the parent, a distribution thereof would clearly be a return of capital. However, should the same view of the distribution obtain if the paid-in surplus arose as a result of capitalizing earned surplus in connection with a stock dividend? Such paid-in surplus retains its identity as "earnings and profits" for tax purposes, of course. Is capitalization of a stock dividend at "fair value," i.e., in an amount exceeding the required legal minimum, more a matter of stock exchange financial policy for listed corporations and less a matter (if at all) of accounting principle? Should the fact that the paid-in surplus had its origin in earned surplus *or* the fact that an irrevocable transfer from earned surplus has been formally effected, be controlling as to whether a subsequent distribution is "income" to the recipient?

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In our opinion further, we believe the rule of informative disclosure requires that the parent company indicate to its stockholders *that paid-in surplus is the source of its current dividend payment.* Regarding the matter of balance-sheet presentation, we would be inclined to follow the treatment described on p. 22.28 of the *Accountants' Handbook* (*op.cit.* footnote 2).

Perhaps one further point should be clarified or emphasized: Corporation statutes as such generally do not deal with the treatment of corporate distributions from the standpoint of the *recipient.* However, they do customarily set forth criteria as to when corporate distributions may legally be made and the circumstances under which distributions are illegal. Furthermore, the better corporation statutes also expressly require that *proper notice* be given to stockholders when "liquidating dividends," or dividends "out of capital" or "out of capital surplus," are paid. In this connection, see "Section 41 (revised) – Distributions from Capital Surplus" (in *Model Business Corporation Act, op.cit.* footnote 2).

Regarding the equity versus cost methods of carrying a parent's investment in its subsidiaries, see the discussion touching on this matter in *Montgomery* (*op.cit.* footnote 2) at pp. 290-1; in the *Accountants' Handbook* (Ronald Press Co., N.Y., 1943 ed.) at pp. 1070 and 1073; and in the article "Some Problems Regarding Consolidated and Parent Company Statements" (*The Journal of Accountancy* for November, 1953), see question and answer number 18.[4] See also the discussion under the heading "Unconsolidated Subsidiaries in Consolidated Statements" in par. 19 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959). It is our understanding the Committee on Accounting Procedure intended to confine its expressed preference for the equity method to "unconsolidated subsidiaries in consolidated statements" situations. For parent-company accounting purposes, we believe the committee favored the cost method of carrying the investments in subsidiaries.

[4] For a helpful and clarifying discussion of the "equity method" in a reference published subsequent to this exchange of correspondence, see the chapter entitled "Intercorporate Investments" in *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1962 ed.).

Inquiry **346**

Distribution-in-kind — dividend paid in substantially appreciated securities owned by declaring corporation

"One of our corporate clients plans to pay a substantial dividend in securities owned. These securities have a market value much in excess of the acquisition cost. It is the desire of the client to record this appreciation of value in the earnings history of the company without jeopardizing the non-taxable feature of the increment to the corporation in such distributions.

"The investments to be distributed to the stockholders have been owned by the company for about eight years. During this period of time there has been considerable appreciation of value in these securities which has heretofore not been recognized in the accounts of the company.

"The management wishes, in some way, to record this increment in the permanent earnings history of the company so that the stockholders and others who look at and analyze the past operations of the company will be aware of the total earnings over a period of years.

"Will you please give me your opinion as to the following:

"1. The proper accounting treatment on the books of the client for the increment in securities distributed to the stockholders as a dividend-in-kind.

"2. The proper presentation in the annual-audited statement for the increment in securities distributed to the stockholders as a dividend-in-kind."

Our Opinion

None of the Institute's official bulletins has dealt with the question raised in your letter. Whether the difference between the cost and market value of property distributed by a corporation as a dividend-in-kind may properly be recognized as income is quite clearly an unresolved and controversial question.[1]

Our own personal opinion is that the increment in question should *not* be reflected "in the permanent earnings history of the company." We are inclined to give considerable weight to the arguments advanced at the top of p. 129 of Moonitz (*op.cit.* footnote), viz.:

> ... that no profit has been "realized" by the corporation, that profits can be realized only by sale, and that if the increased valuation of the investment is to be shown at all, the credit (representing the differential between cost to the accounting entity and its current fair market value) should be reflected in an appraisal surplus or other "unrealized" surplus account.

Although we feel that disclosure of the fair value of the property being distributed is most desirable, we believe the dividend obligation should be set up and measured by the carrying value of the property being distributed (which in the absence of an appraisal writeup should be cost).

The appraisal writeup prior to making a distribution-in-kind does not seem to make too much accounting sense, either. If, upon distribution, the cost of the securities was charged to Retained Earnings and the appraisal increment portion to Appraisal Surplus, then the company's accounts would be *in statu quo ante,* i.e., in the same condition they would have been in had the writeup never been recorded. On the other hand, if, upon distribution, the entire appraisal amount was charged to Retained Earnings, then the Appraisal Surplus would remain on the books although the specific assets giving rise to it would no longer be owned by the company. In effect, Retained Earnings would have been capitalized to the extent of the increment. The patent fact is that the corporate accounting entity never *did* realize the increment in value although it *could have* realized it net of taxes, so why (if this were possible, assuming distribution) record such increment "in the permanent earnings history of the company"?

[1] See *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) p. 22.27; *Advanced Accounting,* by Newlove and Garner (D. C. Heath & Co., Boston, 1951, vol. 1) pp. 202-03; *Principles of Accounting — Intermediate,* by Finney and Miller (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958) pp. 133-4; *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) pp. 404-05; and *Accounting — An Analysis of Its Problems,* by Moonitz and Staehling (Foundation Press, Inc., Brooklyn, 1952) pp. 127-9.

Inquiry 347

Classification of amounts withheld from patronage dividends for purchase of stock in cooperatives

"We prepare a certified audit report on a cooperative in our locality and have encountered a problem as to classification.

"This cooperative distributes all of its income to the various patrons. The patrons are required to hold a certain amount of capital stock in the cooperative based upon their purchase requirements. Where a patron cannot purchase all of the required stock, he is obliged to acquire same through payments withheld from patronage dividends.

"Our question is this: Should the liability for patronage dividends in its entirety be classed as a current liability, or should the portion of this liability applicable to the purchase of stock in the cooperative be segregated and classified under 'Other Liabilities' with an explanation?"

Our Opinion

In our opinion, the gross amount of the liability for patronage dividends or refunds should be shown short in the current liability section of the balance sheet; the portion thereof withheld for the purchase of stock should be deducted therefrom, and the net patronage dividends or refunds currently payable shown extended to the margin.

Depending upon whether the "retain" or withheld portion has essentially all the attributes of debt (especially if it has a definite maturity date) or whether it more nearly represents "true" capital, such withheld portion of the patronage dividends or refunds should then be reflected either as a long-term liability or as part of net worth (capital, or "patrons' equities").[1]

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[1] For an excellent general reference on cooperatives, see the booklet entitled *Accounting Practices, Auditing Standards and Terminology for Agricultural Cooperatives* (published by National Society of Accountants for Cooperatives, Columbus, Ohio, 1952).

STOCK DIVIDENDS

Inquiry 348

Auditor's report when stock dividend capitalized at required legal minimum rather than at "fair value" of dividend shares

"Your opinion is requested as to the effect on the opinion section of a proposed audit report, of circumstances which are described below:

"The client is engaged in the business of purchasing tracts of land, developing these tracts, subdividing them into building lots and selling the lots. Sales, in most instances, are accomplished through sales contracts with minimum down payments and a series of subsequent monthly payments. In such instances, title is passed after the final monthly payment has been received from the customer. This information is given because I believe that it will indicate a degree of speculativeness in the company's operations.

"The company was organized during 1957, and its stock was closely-held until 1959. During 1959, the company was reorganized, and stock was sold publicly. Selling prices during the period 1959 through 1961 ranged from $2.50 to $3.50 per share. Par value is $.10 per share. Common stock only has been issued. No stock sales of consequence have been made since 1961, over two years ago.

"The company has declared and distributed stock dividends as set forth below. No dividends – other than those listed – have been paid:

1960 – 10 per cent stock dividend, equivalent to 30,720 shares
1961 – 10 per cent stock dividend, equivalent to 32,081 shares

"The 1960 dividend was charged to earned surplus at $3.25 per share, and the 1961 dividend was charged to earned surplus at $3.50 per share. These amounts were based on the latest prices at which the company had offered and sold its stock.

"An additional 10 per cent stock dividend is contemplated during July, 1963, at which time it is estimated that the earned surplus account will stand at approximately $65,000. Book value per share should be between $1.25 and $1.50 per share. The Board of Directors wishes that earned surplus be capitalized – as concerns the July, 1963 dividend – at the rate of $.10 per share, which represents the par value of the stock.

"A copy of a letter from the company's attorney, as endorsed by the president, is enclosed as additional information. This letter sets forth the Board's position with respect to the assigned value of the stock to be distributed as a dividend, as regards the effect on the earned surplus account."

Attorney's Letter to Our Correspondent

"The purpose of this letter is to state the position of the subject corporation with respect to a contemplated stock dividend, payable, to stockholders of record, sometime in July, 1963.

"The Corporation, in past years, has paid annual stock dividends. Such dividends have been equal to 10 per cent of the outstanding shares.

"When such dividends were effected, a portion of the earned surplus account was dedicated to paid-in surplus. In past years, the Corporation had not concerned itself with the fact that the amount taken out of the earned surplus account was on the basis of the last offering price.

"The Corporation's stock is held publicly. A substantial portion of the stock has been marketed as a result of registered securities issues. This stock, however, has no actual market (in the sense that a market exists for a stock which is traded over-the-counter or through a registered exchange). This is true now, and it has always been true.

"The Board of Directors has met to consider the question of what the fair value of the Corporation's stock is. They noted that no stock has been offered to the public for over two years. They further noted that the position of the Corporation is such that its activities represent, to a considerable extent, heavy speculations.

"All factors considered, the Board concluded that any designation of value by them would be no more than a gross conjecture.

"They considered book value and determined there was no correlation between the Corporation's book value and its fair value. They considered the last offering price and came to a similar conclusion.

"The Directors conclude that it is their feeling *that any assignment of fair value per share would be misleading and misrepresent the financial position of the Company.*

"It is the feeling of the Directors that any amount assigned in excess of par would indicate that the Directors were inclined toward such a given value – when, in truth, such an inclination does not exist.

"The Directors suggest that the financial statement of the Corporation should be prepared on the basis of capitalizing the par value of the stock declared as a dividend, and without any adjustment whatsoever in the earned surplus account. The Statement of Financial Condition should contain an appropriate footnote, and explanation.

"If absolutely necessary, the Directors would voice no objection to an exception in the audit report; however, they do not feel that the circumstances are such as to cause an exception to be indicated.

"In view of this situation, as recited in this letter, we will appreciate your careful evaluation of the situation and our recommended procedure.

"If you feel it is appropriate, we request you to seek an opinion from your professional association."

Our Opinion

We believe the *three* exchanges of correspondence with other members of the Institute relating to the matter of accounting for stock dividends which *directly follow* this opinion, may help considerably in providing background on the Institute's bulletin dealing with this matter [chapter 7B, esp. par. 10, of *Accounting Research and Terminology Bulletins* (AICPA, 1961)], and in indicating some of the problems to which it gives rise.

We have carefully considered the facts and circumstances outlined both in the attorney's and your letter, and have come to the conclusion that, although appropriate disclosure should be made in a footnote to the financial statements of the salient facts concerning the current stock dividend and how the board's capitalization policy differs (should we say "perforce"?)[1] from that adhered to in connection with prior years' declarations of dividend shares, we do not believe it mandatory that you take an exception in your report, i.e., qualify your opinion, basing same on the first two "standards of reporting."[2] Ab-

[1] Assuming 352,891 shares presently outstanding, a 10 per cent stock dividend capitalized at 10¢ would require total capitalization of $3,529. However, capitalization at about $1.85 per share would exhaust the entire estimated earned surplus of $65,000.

[2] The first two auditing standards of reporting, are:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period. [See *Generally Accepted Auditing Standards — Their Significance and Scope* (AICPA, 1954) at p. 45. Cf. *S.A.P. No.* 33 (AICPA, 1963) at p. 16.]

sent disclosure by footnote in the financial statements, however, we then believe you would be required to make "necessary explanation" of the salient facts in a separate second paragraph of a standard short-form report, in accordance with the requirements of the third reporting standard, viz.: "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

The conclusion expressed above to the effect that reporting standards (assuming adequate disclosure) would not necessitate a qualification of your opinion if the contemplated dividend is capitalized in terms of the minimum legal requirement (10¢ par value per dividend share), is based on the following subconclusions, or considerations, viz.:

1. In our opinion, chapter 7B of *Accounting Research and Terminology Bulletins*, especially par. 10 thereof, does not spawn or voice a new accounting *principle* and, of course, the first reporting standard relates to accounting *principles* per se. In this connection, it should be noted that the recommended procedure of capitalizing dividend shares at fair value (when such shares are less than 20 per cent or 25 per cent of shares previously outstanding) is rationalized in par. 10 primarily in terms of "the public interest," not accounting principle. Paragraph 14 (q.v.) of chapter 7B offers evidence that the procedure in question is viewed as a "recommendation," not an ironclad requirement. The history of the committee's recommendation of a capitalization standard for the issuers of certain stock dividends indicates that the motivation relates little to any accounting principle[3] but much to consideration of public corporate policy (i.e., attempting to break or brake the practice by some companies of "needling the market" through recurrent small issuances of dividend shares). In this connection, witness the identical *requirements* for capitalization of stock dividends at fair value as set forth in the *Company Manual* of the New York Stock Exchange.[4] See also the Calkins and Mason dissent at p. 54 of chapter 7B.

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[3] As we see it, the sole relevance to accounting principle is in the realm of fair presentation or adequate disclosure.

[4] Since you state that stock has been "sold publicly" and attorney states that a "substantial part of the stock has been marketed as a result of registered securities issues," would this New York Stock Exchange *requirement* affect your client's situation? Does client file with SEC or with the New York Stock Exchange, or is this an intrastate issue?

INQUIRY: 348

2. Having stated the foregoing conclusion, we believe it follows that you would not have to qualify your opinion on the financial statements on grounds of inconsistency in the employment or application of accounting principles. For authoritative discussion to the effect that the second standard of reporting (the consistency standard) has reference to a change or changes in accounting *principles* employed and "The consistency standard is aimed at comparability of the financial statements of the current year with those of the *preceding* year, . . ." see pp. 44-8 of *Statements on Auditing Procedure No. 31, Consistency* (AICPA, 1961). Cf. *S.A.P. No.* 33 (AICPA, 1963) at pp. 43 and 45.

This having been said, we advert to the nature of the disclosure to be made either as statement footnote or as "necessary explanation" in your report. In the *first* exchange of correspondence *directly following* this, see the footnote used in that situation. Taking the cue therefrom, perhaps a footnote somewhat along the following lines would be appropriate in your client's case, viz.:

> Ten per cent stock dividend declared, and X dividend shares issued. Transfer of Y dollars, made to capital stock account representing capitalization in terms of the legal minimum requirement (X shares @ $.10 par value per share). Market value of shares not currently ascertainable at declaration date. 1960 and 1961 stock dividends capitalized at $3.25 and $3.50 per share, respectively, the latest prices at which the company had offered and sold its stock.

Incidentally, there appears to be some conflict between the following statements taken from the attorney's and from your letter:

> The Directors suggest that the financial statement of the Corporation should be prepared on the basis of capitalizing the par value of the stock declared as a dividend, and *without any adjustment whatsoever in the earned surplus account.* The Statement of Financial Condition should contain an appropriate footnote, and explanation. (attorney's letter, *our emphasis*)

> An additional 10 per cent stock dividend is contemplated during July, 1963, . . . *The Board of Directors wishes that earned surplus be capitalized* – as concerns the July, 1963 dividend – at the rate of $.10 per share, which represents the par value of the stock. (your letter, *our emphasis*)

This, of course, leaves us in a quandary as to just which surplus the board intends to capitalize. For some comments on the matter of declaring a stock dividend out of capital or paid-in surplus, see the *third* exchange of correspondence *directly following* this.

In all of this, one is compelled to query: What business or other purpose is sought to be served by declaration of a stock dividend under the circumstances described?

Inquiry **349**

Capitalizing stock dividend at fair value where declaring corporation has insufficient earned surplus

"Your advice and suggestions are requested in a matter of great importance to me, particularly so since it involves a very good client.

"The question has to do with stock dividends and the proper amount to transfer from retained earnings. Assume a capital structure as follows:

Capital Stock – 750,000 shares authorized – 470,000 shares outstanding. Par value at $.50 per share	$235,000
Capital in excess of par value	395,000
Retained Earnings	75,000

"This stock is not a listed stock, but is traded in many parts of the country 'over-the-counter.' There are hundreds of stockholders. The capital in excess of par value represents amounts received over par value by the company in stock sales made to directors. These sales were always made at above market price.

"In the state of incorporation, it is quite likely that the 'capital surplus' would be a legal source for dividends even though the matter has not been ruled on directly. The law of the state in question allows stock dividends when surplus is sufficient, provided an amount equal to the par value of the stock is transferred from surplus to capital.

"With the above assumptions and facts, here is the problem. A 5 per cent stock dividend was declared; as a result, 23,500 shares were issued to the stockholders. A transfer of $11,750 was made from retained earnings to capital stock – 23,500 shares at $.50 per share.

The market value of the stock may have been at least $10 per share at the time. Using market value at the time of the stock dividend declaration as a basis for the transfer from retained earnings, we would arrive at the amount of $235,000 – 23,500 shares at $10 per share.

"I will be faced with the same situation for 1962, since a 10 per cent stock dividend has been declared. The capital structure this time will be:

Capital Stock – 750,000 shares authorized – 510,000 shares outstanding. Par value at $.50 per share	$255,000
Capital in excess of par value	551,750
Retained Earnings	80,000

"As a result of this new 10 per cent stock dividend in 1962, an additional 51,000 shares will be issued to the stockholders. I am sure the company will transfer $25,500 from retained earnings – 51,000 shares at $.50 per share. The market value of the stock would amount to $510,000.

"I am familiar with chapter 7B, 'Stock Dividends and Stock Split-Ups,' in *Accounting Research Bulletin No. 43*. I have also reviewed the section on stock dividends in *Accounting Trends and Techniques*, (AICPA, 1959). I note in this section that company after company transfers from retained earnings an amount equal to the market value of the shares issued as a stock dividend. I also note that the *Accountants' Handbook* (Ronald Press Co., N.Y., 1943) takes a position against using market value as a measure of the amount to be capitalized in the case of a stock dividend.

"You can see the position I am in. Two stock dividends with market values amounting to $745,000 with transfers from retained earnings amounting to $37,250. The company has met the legal requirements, but what is my position in expressing an opinion? Under the circumstances, can I express the regular short-form opinion and footnote the report similar to this:

> Five per cent stock dividend declared – 23,500 shares issued. $11,750 transferred from retained earnings. Market value at declaration date at $10 per share, $235,000.

"Incidentally, I have discussed this matter with two leading practitioners who are both CPAs and attorneys, one who is very active in accounting circles. Neither one had ever given this matter any thought. They have allowed the transfer from retained earnings at par value with no regard for market value. They both voiced disapproval of market value as a basis for the transfer from earned surplus."

Our Opinion

In our opinion, it is proper under the circumstances you describe, to express the regular short-form opinion and footnote the facts in the manner set forth in the next to last paragraph of your letter. We have no reason to believe the Institute's Committee on Accounting Procedure ever intended that the bulletin on "Stock Dividends and Stock Split-Ups" be followed invariably, i.e., even when the required procedure of capitalizing the dividend shares at fair value leads to absurd accounting results.

Two relevant exchanges of correspondence with other Institute members which we believe you will find helpful, *directly follow*. In the first exchange which follows, see especially the third and fourth paragraphs of our reply.

Inquiry 350

May parent capitalize undistributed earnings of subsidiaries to account retroactively for fair value of dividend shares?

"I would like to refer the following problems to your Technical Information Service:

"Corporation P with several wholly-owned subsidiaries has followed the practice for several years of issuing annual stock dividends of a nominal per cent. The excess of fair market over par value has not been transferred from earned to capital surplus, and it is deemed necessary at this time to make the transfer. The difference between par and market value is sufficiently high, however, so as to result in a deficit in the earned surplus account after transfer.

"Investment in subsidiaries is carried at cost.

"Would it be proper to carry the investment in subsidiaries at book value with a corresponding credit to earned surplus which would be sufficient to offset the prospective deficit? Each of the subsidiaries has a substantial earned surplus, and on a consolidated basis, there would be no deficit. However, unconsolidated statements are used for various purposes, and it is desirable if possible to avoid showing the deficit on the books of the parent company.

"If not, is there any other solution to the problem or a preferred method of handling the above situation?"

Our Opinion

At the outset, perhaps we should mention that if the client under consideration is a *closely-held* corporation, the requirement that earned surplus in the amount of the "fair value" of dividend shares issued be capitalized would not be operative or applicable. [See par. 12, chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953).]

If, on the other hand, it is concluded that the client is a *publicly-held* corporation and *should have* capitalized earned surplus in the amount of the fair value of dividend shares issued (as required by par. 10, chapter 7B of *A.R.B. No. 43*), then it would appear that if the *Bulletin* is to be supported, the excess of fair value over the par or stated value of dividend shares issued in the past should now be retroactively capitalized. (We assume that when the several stock dividends were issued, earned surplus was capitalized only to the extent of legal requirements, i.e., in the amount of the par or stated value of the shares.) *In the absence of* adjusting the parent's investment in subsidiaries as you suggest, and charging the excess of the amount required to be capitalized over the parent's available earned surplus to the "undistributed earnings of subsidiaries" thus taken up on the parent's books, the result of the retroactive adjustment would as you point out be a *deficit* on the parent's books.

This result, in our opinion, serves no useful accounting purpose: the parent would be reflecting additional capital which theretofore it had not actually realized. And unless the deficit were specially described as arising from stock dividend declarations (which in turn would need clarification), the corporation would otherwise be reflecting a deficit which readers of the statement might interpret as an accumulated deficit from operations even though in fact the corporation's past operations may have resulted in accumulated earned surplus. In other words, by following the literal requirements of the *Bulletin,* a bookkeeping entry would be made with the result that capital never realized or received by the corporation would be reflected in the statements as *impaired!* Question might also be raised whether a deficit created in this fashion would have to be "made up" before any further dividends may be declared. We are not aware of any legal or accounting rules to that effect. Furthermore, we see no reason why such a deficit, once created, may not be eliminated in an accounting quasi-reorganization. (See chapter 7A, *A.R.B. No. 43.*) This, then, brings us full circle.

Although chapter 7B of *A.R.B. No. 43* does not cover the situation outlined in your letter, we do not believe it intended the anomalous results pictured above. Accordingly, it seems to us that if the retroactive capitalization of earned surplus were to be limited to the amount of earned surplus actually available, that would be sufficient compliance with the intent of the *Bulletin.*

Regarding your question whether it would "be proper to carry the investment in subsidiaries at book value with a corresponding credit to earned surplus which would be sufficient to offset the prospective deficit," we believe such procedure may be technically rationalized only on the basis of a definitely *minority* practice.

In the Institute's *Survey of Consolidated Financial Statement Practices* (1956), only 6 of 100 companies having unconsolidated subsidiaries "took up" the undistributed earnings of such subsidiaries. Only 2 of the 6 took such undistributed earnings directly into income. (We think this practice may be supported but only on tenuous grounds.)[1] The other 4 credited the undistributed earnings (prior

[1] The foregoing remarks were written prior to publication of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959). Paragraph 19 thereof states that of "two methods of dealing with unconsolidated subsidiaries in consolidated statements . . . the preferable method . . . is to adjust the investment through income currently to take up the share of the controlling company . . . in the subsidiaries' net income or net loss, . . ." The committee does not state whether the method for which it expresses a preference in the case of "unconsolidated subsidiaries in *consolidated* statements" is equally preferred where *parent company* statements are presented. On this general question, however, see question and answer number 18 in the article "Some Problems Regarding Consolidated and Parent Company Statements" in *The Journal of Accountancy* for November, 1953, pp. 570-6 at p. 576.

to actual realization through dividends) to capital, i.e., to a special surplus account. Basically, we believe a special surplus account such as "Undistributed Earnings of Subsidiaries" represents a species of revaluation surplus. Thus, it is questionable whether retroactive compliance with par. 10, chapter 7B of *A.R.B. No. 43* can be achieved by charging a portion of the fair value of dividend shares issued, to a surplus account which on the parent's books, measures unrealized earnings. Also, if the charge were made to such surplus account, the balance thereof would no longer correctly measure the "Undistributed Earnings of Subsidiaries."

It also should be mentioned that if the parent's investment in subsidiaries were to be adjusted to the underlying net equity, an exception as to consistency would have to be taken in the accountant's report.

To summarize our position: The purpose of chapter 7B of *Accounting Research Bulletin No. 43*, as we understand it, is to inhibit the frequent declaration of small or nominal stock dividends. Since the several dividends involved here are now "water over the dam," capitalization of earned surplus to the extent now available would seem to be a sufficient retroactive compliance with chapter 7B of *A.R.B. No. 43.*

Inquiry from Law Firm **351**

Capitalization of earned surplus at fair value of dividend shares vs. statutory allowance of stock dividends out of capital surplus

"Our attention has been called to your research bulletin dealing with the payment of corporate stock dividends.

"Under the laws of many of the states of the Union, it has been recognized without a question that dividends are payable out of capital surplus. Where such dividends are payable out of capital surplus in full accordance with the law, the above referred to research bulletin, issued by the American Institute of Certified Public Accountants, would appear to hold that such stock dividends should be charged *against the earned surplus* of the company at the fair market value of the shares.

"Naturally, if the dividend is payable out of capital surplus, then the charge should be made against the capital surplus.

"We would appreciate your giving us some clarification on this matter."

Our Opinion

Chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953) requires that *earned* surplus be capitalized in "an amount equal to the fair value of the additional shares issued" in cases where stock dividends involve "the issuance of additional shares of less than, say, 20 per cent or 25 per cent of the number previously outstanding." Exceptions to the requirement that *earned* surplus be capitalized in the amount of the "fair value" of the dividend shares, are made in cases involving relatively large or extraordinary stock dividends and closely-held companies. (See par's 11 and 12, chapter 7B, *A.R.B. No. 43.*)

The Institute's position with respect to the accounting treatment of stock dividends by the issuing corporation corresponds with the announced policy of the New York Stock Exchange in authorizing the listing of additional shares to be distributed pursuant to a stock dividend. We understand the Securities and Exchange Commission also supports the position of the Institute and the Exchange.

We do not believe that the above-mentioned recommendation of the Institute or announced policy of the New York Stock Exchange can be reconciled with the procedure, legally permissible in many states, of declaring a "stock dividend" out of capital or paid-in surplus. In this connection, we also note section 40(d) of the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with the American Bar Association) which provides that "Dividends may be declared and paid in its own authorized but unissued shares *out of any surplus* of the corporation . . ." (*our emphasis*) [if par value shares, aggregate par value of shares issued to be transferred from surplus to stated capital; if shares without par value, amount fixed by board resolution to be transferred from surplus to stated capital and stockholders notified as to amount transferred].

If a board in full accordance with the law declares, say, a 15 per cent dividend out of paid-in or capital surplus and management reflects the facts by a charge to such surplus, the effect upon the CPA's report is problematical — he may decide to qualify his opinion on the balance sheet because of the *Bulletin's* recommendation or merely disclose the fair value of the dividend shares issued.

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Incidentally, several months ago when an Institute member had raised a question similar to yours, we called the Department of Stock List of the New York Stock Exchange to determine whether they had any ruling on, or policy regarding, payment of dividends out of capital surplus in the presence of available earned surplus. We asked specifically whether they would countenance dividends being charged to capital surplus arising from capitalization of earned surplus in connection with stock dividends. The person with whom we talked stated only that the case had not as yet presented itself, and that if the case did come up, the Exchange would scrutinize the situation closely to determine whether it had a "valid business purpose" or reason. It goes without saying this answer was not too helpful; but we fully understand the respondent's perplexity now that your question presents us with a quandary.

It is also relevant to note that the following statement at p. 414 of the 1949 edition of *Montgomery's Auditing* (an authoritative reference on accounting and auditing matters) is *deleted* from the 1957 edition of that publication, viz.:

> When paid-in surplus has been created from payments by stockholders in the form of premiums or assessments, it may be desirable to capitalize it formally through the declaration of a stock dividend. Such dividends represent nothing more than a formal capitalization of what has been contributed as capital by the stockholders.

This, of course, makes good sense, and accordingly, we are somewhat at a loss in understanding the reason for the deletion. Formal capitalization of paid-in or capital surplus would *in fact* transfer surplus "to the category of permanent capitalization," i.e., to the legal or stated capital of the corporation – which apparently, chapter 7B, par. 10 of *Bulletin No. 43* purports to do.

Personally, we believe there is much to be said for the Calkins and Mason dissent to the *Bulletin* in question (at p. 54) viz.:

> Messrs. Calkins and Mason approve part one, but believe part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the shareholder may think otherwise. They believe it is inappropriate for the corporate entity to base its accounting on considerations of possible shareholder reactions. They also be-

> lieve that part two deals with matters of corporate policy rather than accounting principles and that the purpose sought to be served could be more effectively accomplished by appropriate notices to shareholders at the time of the issuance of additional shares.

It is also our own personal view that a great deal of the difficulty in this area is semantic. In this connection, note the suggestion in the Wilcox article cited in the footnote below, that "it would be a good idea to use the term 'split-up' when no amount was capitalized, 'capitalization' when charges were made to paid-in or other capital surplus accounts, and 'dividend' when charges were made to earned surplus."

It is difficult to give a capsular clarification of this whole matter, for you may have asked us to reconcile the irreconcilable.[1]

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[1] However, the rationale (or rationalization), pro and con, of the accounting treatment of stock dividends, may be found in the following references:

1. *Accounting Research Bulletin No. 11, Corporate Accounting for Ordinary Stock Dividends* (AICPA, September, 1941 – now superseded, but important historically).
2. Chapter 7B, "Stock Dividends and Stock Split-Ups" (in *Accounting Research Bulletin No. 43,* AICPA, 1953).
3. "Accounting for Stock Dividends and Stock Split-Ups," by Walter L. Schaffer (at pp. 144-50 of *Accounting, Auditing, Taxes, 1953,* papers presented at AICPA's 66th Annual Meeting). Typographical error at p. 145 in quoting important excerpt from original bulletin – see original bulletin at top of p. 103.
4. "New York Stock Exchange Issues New Policy on Accounting for Stock Dividends" (in *The Journal of Accountancy* for May, 1953, p. 604). In the same issue, see the item "Charge Stock Dividends at Par, Not Market: A Dissent from ARB No. 11," at p. 543 *et seq.*
5. "Accounting for Stock Dividends: A Dissent from Current Recommended Practice," by Edmund B. Wilcox (in August, 1953 issue of *The Journal of Accountancy* at pp. 176-81).
6. "Stock Dividends and Concepts of Income," by George O. May (in October, 1953 issue of *The Journal of Accountancy,* at pp. 427 *et seq.*).
7. In Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957) see especially at pp. 55, 140, 149-65.
8. *Cases and Materials on Law and Accounting,* by Schapiro and Wienshienk (Foundation Press, Inc., Brooklyn, 1949) see pp. 238-47 and 371-3.
9. *Materials on Accounting,* by Amory and Hardee (Foundation Press, Inc., Brooklyn, 1953) see pp. 332-7.
10. "Periodic Stock Dividends," by J. C. Bothwell, Jr. (in *Harvard Business Review* for January, 1950, at pp. 89-100). This is an excellent "background" article.
11. "Stock Dividends and Stock Splitups,' by M. D. Littler (in *The Michigan CPA* for May, 1953, at pp. 1, 15-16).
12. For additional "background" material, see the extended comment upon the dividend policy of the North American Company in the May, 1928 issue of *The Journal of Accountancy* and also the exchange of correspondence between Col. Robert H. Montgomery and Herbert C. Freeman on this subject in the July, 1928 issue of *The Journal of Accountancy,* at pp. 42-7.

INQUIRY: **351**

Inquiry 352

Determination of "fair value" for purpose of capitalizing earned surplus in connection with stock dividend

"Please clarify *Accounting Research Bulletin No. 43* in regard to charging earned surplus account with the fair value of shares issued as a stock dividend. Our client has declared a 5 per cent stock dividend. For the past year, the quotable market for the shares of our client has been in the range of 12 to 30. Before going ex-dividend the shares were traded at 27 bid. Ex-dividend, the shares were traded at 25½ bid. The shares of our client are traded over-the-counter. It was suggested to our client that the practice has been to take an average of quotations for the year as the 'fair value' of the shares issued as a stock dividend."

Our Opinion

The Institute's Committee on Accounting Procedure has not issued any clarification of the term "fair value" as used in par. 10, chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953).

Several months ago we talked with a staff man in the Department of Stock List of the New York Stock Exchange regarding the date as of which "fair value" is to be determined when capitalizing earned surplus upon the issuance of a stock dividend. The *Company Manual* issued by the New York Stock Exchange does not indicate one way or the other whether market or fair value as of a specified date, or a representative average, should be used.

However, our informant stated that an average was generally not acceptable, and that the majority of companies use market price at the close of the day preceding the board's action. He stated that it was also acceptable to use the price on the date the stock sells "ex," i.e., three days preceding the record date, *or* to use market price at the record date, especially if paying fractions in cash. He stated further that the Exchange has no quarrel with rounding off, say from 28⅜ to 28; and that if there were no quotation on the particular date to be used (relatively rare), the mean between bid and asked may be used.

Our own personal view is that the above may have particular relevance in the cases of stocks having a stabilized market and current daily quotations. In your particular case, it seems to us the most recent quotations, while important, should not be considered controlling. The breadth and depth of the market in which quotations occur and trends in quotations over a reasonable period are factors to be evaluated and taken into account. It may well be that a representative average of quotations may be a more realistic "fair value" in your client's case.

Inquiry 353

Surplus transferred to "stated capital" by subsidiary pursuant to stock dividend — propriety of including capitalized amount in parent's and in consolidated earned surplus

"An accounting problem has been encountered for which it is my belief we have the correct solution. However, I find no authority to substantiate the conclusion reached. Therefore, I am taking the liberty of submitting the problem to you in case you may have previously encountered it and can agree or disagree with our conclusion.

THE PROBLEM

"The problem is simply whether to have a parent company record in its investment account and earned surplus a stock dividend of a subsidiary whereby the subsidiary capitalized $162,000 of earned surplus.

THE FACTS

"The subsidiary company is an insurance company. It was organized with a paid-in capital of $38,000 which was the parent's investment therein. The operations were very profitable and a sizable earned surplus resulted. In order to qualify it to do business in one of the states, the capital account of the insurance subsidiary was increased to $200,000 which was accomplished by capitalizing $162,000 of earned surplus and issuing additional shares to the parent company since the stock had a par value of $1.00 per share.

"In consolidation, the parent's investment of $38,000 is eliminated against the $200,000 capital of the subsidiary and the excess of $162,000 is reflected in consolidated earned surplus.

"No problem existed when the only statements required were on a full consolidated basis. However, for several reasons, primarily because of its being an insurance operation dissimilar to the activities of the parent (and its other subsidiaries) statements are now required showing (1) consolidated statement of the parent and other subsidiaries and (2) statement of the insurance company separately and (3) total consolidated statement. I think that you can see the result. Statement (1) shows an investment of $38,000 in the insurance subsidiary, statement (2) shows a capital stock account of $200,000, and statement (3) shows neither one but an increase in consolidated earned surplus of $162,000. Obviously this can create a continuing question to bankers and others.

PROPOSED SOLUTION

"Increasing the investment of the parent in the insurance subsidiary by $162,000 and crediting earned surplus of the parent company by $162,000 would eliminate the problem. This is what we propose to do – not necessarily because it solves the problem, but be-because we think it is fundamentally sound accounting. The surplus of the subsidiary to the extent of $162,000 has been permanently capitalized and the investment of the parent, we think, should give effect to this permanent investment addition. And since the parent is capitalizing in its investment account earned surplus, the parent company's credit would be to earned surplus. Incidentally, the assets of the insurance company are substantially all cash, securities and other liquid assets with no question on value of underlying assets.

"Another related factor is that the parent company plans to increase its own capital account by capitalizing a portion of earned surplus without the issuance of additional shares. If the $162,000 is included in earned surplus of the parent, it will become a part of earned surplus so capitalized."

Our Opinion

In our opinion, the proposed solution is fundamentally unsound. We further believe that the problem would not have presented itself initially [i.e., the incongruous situation reflected in your "statement (3)" whereby the whole (consolidated earned surplus) is $162,000 greater than the sum of its parts (the combined earned surpluses of the entities being consolidated)] if a different treatment had been followed in preparing the consolidated statements. This is not to say that you do not have authority for the treatment described in par. 4 of your letter. In point of fact, par. 18 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) supports such treatment.

Be that as it may, our personal opinion is that the *minority* view expressed in the answer to question 2 in the article "Some Problems Regarding Consolidated and Parent Company Statements" (see *The Journal of Accountancy* for November, 1953, at pp. 570-1) has more reason and realism on its side. Accordingly, we believe it would be warranted for purposes of consolidated statements to earmark and designate the $162,000 within the consolidated equity section as "Amount Transferred to Stated Capital of Subsidiary Pursuant to Its Issuance of Stock Dividend."

A subsidiary's capitalization of earned surplus in connection with a stock dividend is, of course, a one-way street – such surplus can never again become earned surplus of the accounting entity initially capitalizing same. True, it *can* be transmuted into earned surplus of the parent company as a result of a liquidating distribution by the subsidiary or possibly a dividend paid out of a "reduction surplus" of the subsidiary, but only then after first applying a portion of any liquidating distribution against the original investment amount as a recovery of capital. We consider it somewhat anomalous to treat surplus capitalized in connection with a stock dividend of the parent as frozen capital (or *relatively* "permanent" capital to the extent a portion of the capitalized amount is reflected as paid-in or capital surplus) while treating surplus capitalized in connection with a stock dividend of a subsidiary (especially where the subsidiary is under a regulatory order to increase its stated capitalization) as unfrozen capital, nay, part of "earned surplus," for purposes of consolidated statements.

To advert to your solution, *strictly* from the standpoint of parent-company accounting, we feel that the adjustment of the investment represents a writeup, an upward departure from cost, and that the correlative credit, whatever designation it goes by, is nevertheless in the nature of an appraisal increment, or unrealized appreciation. It is not the so-called equity method that is involved here, for then the investment account would have been adjusted for the total undistributed post-acquisition or post-organization profits of the subsidiary.

INQUIRY: **353**

You state that "since the parent is capitalizing in its investment account earned surplus, the parent company's credit would be to earned surplus." We feel this is a non-sequitur. It would be more strictly accurate to say that the parent is capitalizing in its investment account an increment which represents a portion of the subsidiary's "permanent," or "formal," or stated, capital.

After receiving the foregoing reply, our correspondent made the following rejoinder:

"My belief is that the accounting which I proposed is sound. Furthermore, the same results would have been achieved had the parent and subsidiary accomplished the transactions on a cash basis, namely, the subsidiary would have paid a cash dividend of $162,000 which would have been credited to earned surplus of the parent through income account. The parent company would then have invested the $162,000 in additional stock of the subsidiary which would have been charged to the investment account for this subsidiary. The only difference in effect would have been an income tax payable by the parent on the cash dividend. This is only an incidental matter which I do not think affects the primary question."

Our Final Comment

The primary question is whether the accounting objective is to reflect transactions as they factually occurred (to the extent this can be done and here it can be done) or to reflect transactions on an "as if," hypothetical, or "constructive" basis. The subsidiary's "permanent" capitalization of $162,000 of its earned surplus and issuance of dividend shares to its parent, did not in point of fact result in any effective divestment of property or rights on the part of the issuing company. In point of fact, the increase of the subsidiary's stated capital puts a portion of its property not beyond the reach but if anything, further from the reach or realization of the parent company, a hindrance of sorts. No cash dividend was ever paid in point of fact. Although $162,000 of the subsidiary's stated capital had its origin or source as "earned surplus," it has forever lost its status *as such,* i.e., in the absence of a liquidating distribution by the subsidiary or its creation of a reduction surplus and distribution thereof.

Inquiry 354

Earned surplus transferred to capital stock in connection with stock dividend — irreversibility once transfer is made

"We have a client, now in process of refinancing, under the following circumstances:

"Common stock is par value stock, which must be issued at not less than par value. At the present time the corporation has one stockholder who has agreed to sell what will be 50 per cent of the outstanding stock to another for $25,000 cash, which is to go to the corporation as operating capital.

"The capital accounts, briefly, appear as follows:

	Earned Surplus	*Capital Stock*
January 1, 1946	0	$ 1,000
December 31, 1954	150,000	1,000
January 1, 1955	51,000	100,000
October 31, 1958	(50,000)	100,000
Proposed	25,000	25,000

"The change in capital structure at January 1, 1955, was a common stock dividend, which was charged to earned surplus at par value.

"We propose, in effect, a reduction in the 1955 stock dividend from $99,000 to $24,000, and a restoration of $75,000 to earned surplus.

"It appears that, in accordance with chapter 7A of *Accounting Research Bulletin No. 43*, the above changes are permissible without the necessity of establishing a dated earned surplus account.

"We propose a notation on the current statement to the effect that the transaction is a reduction, with consent of the stockholders, of shares issued as a stock dividend at January 1, 1955."

Our Opinion

In our opinion, there is nothing in chapter 7A of *Accounting Research Bulletin No. 43* (AICPA, 1953) which would warrant the conclusion drawn in the next to the last paragraph of your letter.

The capitalization of retained earnings in connection with a stock dividend is pretty much a one-way street. A stock dividend, we believe, is revocable until actual issuance of the dividend shares; once the distribution has been made, the amounts of earned surplus transferred to stated capital, or to capital stock and capital surplus as the case may be, may not be directly restored to earned surplus.

Of course, it is possible to create a "reduction surplus" by taking appropriate legal steps to reduce stated capital. We note that the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with American Bar Association) provides that stated capital may be decreased by a distribution in partial liquidation; by an amendment to articles of incorporation; by redemption or reacquisition and subsequent cancellation of stock; or by consent of stockholders in cases involving either reduction of stated value of no-par shares, or reduction of amounts of stated capital assigned to par value shares to an amount not less than the par value. The *Model Act* further provides that the surplus, if any, arising out of a reduction of stated capital of a corporation shall be deemed capital surplus, and that such capital surplus may properly be used to reduce or eliminate any deficit arising from losses. We cite the provisions of the *Model Act* merely because they are for the most part exemplary; your particular situation would, of course, be governed (in the matter of reduction of capital, elimination of deficit, etc.) by the law of the state of incorporation.

Although the *Model Act* provides for the absorption of a deficit by capital surplus, it does not contain a requirement that subsequent earned surplus be dated. However, par. 10, chapter 7A of *Accounting Research Bulletin No. 43* sets forth a financial presentation requirement that earned surplus be dated from the effective date of a readjustment (or quasi-reorganization) involving the elimination of a deficit.

The $25,000 mentioned in the first part of your letter as having been received by one stockholder for the sale of 50 per cent of the outstanding stock, should, in our opinion, be treated as donated capital when paid over to the corporation. Treatment of the amount paid over as a loan payable to stockholder would seem to be unrealistic in view of the fact that the corporation's stated capital is presently impaired by the amount of the deficit.

Although we believe it would be proper to eliminate the deficit against, say, $25,000 of reduction surplus, and $25,000 of donated surplus, pursuant to a quasi-reorganization, from the standpoint of proper financial presentation the subsequent dating of earned surplus would be mandatory, and in no event should earned surplus be restored as a result of such readjustment.

Inquiry 355

"Stated capital" vs. "permanent capitalization" — financial presentation under Ohio statute of stock dividend capitalized at fair value

"I would like to have an expression of your opinion as to the proper balance-sheet treatment of the capitalization of common stock issued as the result of the declaration of a common stock dividend (paid on common stock) under the following circumstances:

"Capital stock and surplus structure at the time of the common stock dividend:

Capital Stock		
Prior preferred stock, 5%, cumulative, etc.		$ 309,000.00
Common stock:		
Class A, non-voting, $.33-1/3 per share par value:		
Authorized 1,050,000 shares; issued and outstanding held in escrow 258,578 shares (Note A below)	$ 86,192.67	
Balance issued and outstanding, 651,622 shares	217,207.33	
Total 910,200 shares Class A	$ 303,400.00	
Class B, voting, $.33-1/3 per share par value:		
Authorized 525,000 shares; issued and outstanding 139,800 shares	$ 46,600.00	
Total common stock		$ 350,000.00
Total capital stock		$ 659,000.00
Surplus		
Paid-in surplus	$ 71,870.75	
Earned surplus	4,202,212.01	
Total surplus		$4,274,082.76
Total net worth		$4,933,082.76

Note A: The conditions surrounding the escrowed stock are not germane to the question at hand, except that this stock did not participate in the stock dividend. Appropriate footnotes appear on the balance sheet explaining this circumstance.

"During the current year a 5 per cent common stock dividend was paid on each class of common stock (excluding escrowed stock) in like kind as follows:

	Class A	*Class B*	*Total*
Shares outstanding on declaration	651,622	139,800	791,422
Rate of stock dividend	5%	5%	5%
Shares issued as stock dividend	32,581.1	6,990	39,571.1
Market value at date of issuance of stock dividend:			
Per share	$ 11.00	$ 11.00	$ 11.00
Total dividend value	$358,392.10	$ 76,890.00	$435,282.10

"*Accounting Research Bulletin No. 43* includes the following statement pertaining to the issuer of stock dividends (p. 51):

> ... the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued.

"We are of the opinion that this has applicability to the case which we are citing and would result in the following capitalization of earned surplus:

	Class A	*Class B*	*Total*
Capital stock issued and outstanding:			
Dividend shares	32,581.1	6,990	39,571.1
Par value	$ 10,860.37	$ 2,330.00	$ 13,190.37
Capital surplus	347,531.73	74,560.00	422,091.73
Total capitalization of earned surplus	$358,392.10	$76,890.00	$435,282.10

INQUIRY: 355

"To simplify the presentation, no consideration has been given to the cash which was paid for fractional shares and which will, of course, reduce the amount of earned surplus to be capitalized.

"Our problem lies in the fact that capital surplus in the state of Ohio is by statute available for the distribution of dividends. The above presentation would, therefore, be misleading to the reader of the financial statement in that he could properly consider the capital surplus available for future dividend distributions.

"We have the following questions regarding balance-sheet presentation of this transaction which we wish to propose for your consideration:

"1. In view of the Ohio state statute referred to, are you of the opinion that the capital surplus could be considered permanent capitalization?

"2. If the answer to '1' above is 'yes,' are you of the opinion that consummation of the transaction would result in the proper capitalization of earned surplus as we have presented it above?

"3. If the answer to '2' is 'yes,' are you of the opinion that the problem as to the availability of capital surplus under the Ohio state statute would be sufficiently explained by a footnote to the financial statements?

"4. Could the stock dividend shares and amount be shown under each classification on the balance sheet on a separate line, in total, designated as follows:

> 'Stock dividend shares at market value on the dividend date: #.........shares $.......... value'?

Thus, the net worth section would read:

CAPITAL STOCK		
Prior preferred stock, 5%, cumulative, etc.		$ 309,000.00
Common stock, Class A, non-voting, $.33-1/3 par value per share:		
Authorized 1,050,000 shares; issued and outstanding:		
Held in escrow – 258,578 shares at par		$ 86,192.67
Stock dividend shares at market value on the dividend date – 32,581.1 at $11 per share		358,392.10
Balance – 651,622 shares at par		217,207.33
Total 942,781.1 shares Class A		$ 661,792.10
Common stock, Class B, voting, $.33-1/3 par value per share:		
Authorized 525,000 shares; issued and outstanding:		
Stock dividend shares at market value on the dividend date – 6,990 at $11 per share	$ 76,890.00	
Balance – 139,800 shares at par	46,600.00	
Total 146,790 shares Class B		$ 123,490.00
Total capital stock		$1,094,282.10
SURPLUS		
Paid-in surplus	$ 71,870.75	
Earned surplus	3,766,929.91	
Total surplus		$3,838,800.66
TOTAL NET WORTH		$4,933,082.76

Under this method, none of the dividend value would be transferred to capital surplus. It would all go into the capital stock section. This handling under Ohio law would of course fix the dividend in permanent capital. The same result would be obtained by the suggestion contained in item "5," as follows:

"5. Should the par value of the dividend shares be shown together with the par value of all other shares, arrive at a total par value of those shares, and then add 'Excess of market value at the dividend date over par value on stock dividend shares,' and show only the amount involved?

The net worth section would then read:

CAPITAL STOCK		
Prior preferred stock, 5%, cumulative, etc.		$ 309,000.00
Common stock, Class A, non-voting, $.33-1/3 par value per share:		
Authorized 1,050,000 shares; issued and outstanding:		
Held in escrow – 258,578 shares		$ 86,192.67
Stock dividend shares – 32,581.1		10,860.37
Balance – 651,622 shares		217,207.33
Total at par value		$ 314,260.37
Excess of market value at the dividend date over par value on stock dividend shares		347,531.73
Total 942,781.1 shares Class A		$ 661,792.10
Common stock, Class B, voting, $.33-1/3 par value per share:		
Authorized 525,000 shares; issued and outstanding:		
Stock dividend shares – 6,990	$ 2,330.00	
Balance – 139,800 shares	46,600.00	
Total at par value	$ 48,930.00	
Excess of market value at the dividend date over par value on stock dividend shares	74,560.00	
Total 146,790 shares Class B		$ 123,490.00
Total capital stock		$1,094,282.10
SURPLUS		
Paid-in surplus	$ 71,870.75	
Earned surplus	3,766,929.91	
Total surplus		$3,838,800.66
TOTAL NET WORTH		$4,933,082.76

Our Opinion

Doubtless, the more usual accounting treatment of the transaction outlined in the early part of your letter would be to reduce earned surplus by $435,282.10, to increase issued and outstanding Class A and Class B stock by $10,860.37 and $2,330.00 representing the respective par values of the Class A and Class B dividend shares, and to increase paid-in surplus by $422,091.73.

Regarding this treatment, you state in your letter, as follows: "Our problem lies in the fact that capital surplus in the state of Ohio is by statute available for the distribution of dividends. The above presentation would, therefore, be misleading to the reader of the financial statement in that he could properly consider the capital surplus available for future dividend distributions."

The Fall, 1955 issue of the *University of Cincinnati Law Review* which comments extensively on "The New Ohio General Corporation Law," throws considerable light on your problem, especially at pp. 479-90 and 493. It appears that the principal criteria in the Ohio statute limiting the payment of dividends are insolvency or potential insolvency (see p. 488 *op.cit.*) and whether or not a particular net worth element is properly construed to be "stated" or legal capital under the statute (see pp. 479-80, top of pp. 486 and 488, and 493). Although a particular balance-sheet classification or presentation may be persuasive, it would not necessarily be conclusive on the question of "availability for dividends."

Use of the term "permanent capitalization" at p. 51 of *Accounting Research Bulletin No. 43* to refer in part to "capital surplus," raises some questions.

It seems to us that the proposed presentations of Net Worth in your letter are definitely on the right track, *provided that* the entire amount of earned surplus capitalized in connection with the stock dividend, constitutes "stated capital" under the statute. Note at pp. 479-80 of the cited reference that under the Ohio statute, the directors must determine the stated capital and set it forth on the books, that the stated value of each outstanding par value share may be more than its par value, and that unless the incorporators, directors, or shareholders have specified the amount of consideration for the share that shall constitute stated capital, the entire amount of the consideration is deemed to be stated capital to be carried on the books as such.

INQUIRY: **355**

Assuming that the entire amount of earned surplus capitalized *is* properly to be deemed "stated capital" (either as a result of specific resolution to that effect by the board or as a result of failure to specify the portion of the total consideration deemed to be stated capital), then it seems to us such entire amount should be reflected as part of the total carrying value of Class A and Class B common shares issued and outstanding. What is now designated "Total Capital Stock" in your proposed presentations of Net Worth, might then properly be designated "Total Stated Capital." This would fit in with the statutory requirement (see p. 493 of cited reference) that "the prescribed financials must consist . . . of a balance sheet . . . (showing) stated capital."

Of course, any portion of the amount of "capitalized" earned surplus which the board expressly *excluded* from stated capital, should presumably be shown as capital surplus on the balance sheet with an indication of its derivation (see top of p. 484 of cited reference).

We do not believe it necessary to show the dividend shares as a separate item in setting forth the stated capital. Information as to the number of dividend shares issued and the capitalized market value at dividend date may appropriately be given in a footnote.

Incidentally, in your letter you refer to "cash . . . paid for fractional shares . . . which will, of course, reduce the amount of earned surplus to be capitalized." If we understand the significance of your remark, it seems to us that, on grounds of equity, the amount of cash paid for fractional shares should be related to the fair value of a full share, not to its par value.

Inquiry **356**

Periodic adjustment of parent company's investment account to reflect underlying net assets of subsidiary — effect of stock dividend?

"Our problem arises as a result of the procedure of recording on the books of the parent company the appreciation in the net worth of its subsidiaries accruing from the subsidiaries' profits and surplus adjustments. The parent's investment account in the subsidiary is adjusted to the subsidiary's book value at date of acquisition and henceforth the investment account is charged and an account captioned 'Undistributed profits of subsidiaries' is credited with the periodic profits of the subsidiaries. As cash dividends are declared by the subsidiary out of surplus accumulated subsequent to date of acquisition, the parent company brings the dividend into income and concurrently reduces the investment account and its undistributed profits account. The parent company brings into its operating income only that portion of the subsidiaries' profits which the parent company realizes through dividends received (out of earnings subsequent to date of acquisition) from such subsidiaries. The parent company does, however, as a final item in its profit and loss statement, reflect the undistributed earnings of its subsidiaries but segregates such undistributed earnings by charging earned surplus. The parent company's balance sheet at all times reflects the accumulated undistributed earnings in the capital and surplus section captioned 'Undistributed profits of subsidiaries,' and its own earned surplus account contains only realized retained earnings available for dividends. We are sure you are familiar with this accrual method of handling the investment in subsidiaries, and while considerable literature has been generated with respect to its impropriety, we have found it to be a workable technique in facilitating the consolidation of the financial statements of subsidiaries with those of their parents.

"One of the results of this procedure is that concurrent with the change in the surplus (subsequent to the date of acquisition) of a subsidiary, the parent adjusts its undistributed profits account so that at all times the balance in this account equals the earned surplus (subsequent to the date of acquisition) of the subsidiary, and this procedure seems acceptable enough when profits and losses and cash dividends are involved. The area in which we are not clear involves charges to the subsidiaries' surplus (subsequent to the date of acquisition) which do not represent losses or cash dividends but rather stock dividends or other adjustments of the capital shares account which affect earned surplus (subsequent to the date of acquisition). In the case of a stock dividend the parent company has been crediting its earned surplus and charging its undistributed profits account for the amount of the stock dividend as measured by the amount transferred by the declaring subsidiary from its earned surplus (subsequent to the date of acquisition) to its capital shares account. Accordingly, on the parent's books, a transfer is made from 'Undistributed profits of subsidiaries' to earned surplus in the amount of the stock dividend and, if we are to accept the theory that the parent company's earned surplus only is available for dividends on the parent's stock, and the undistributed profits of subsidiaries is *not* available for dividends on the parent's stock, then a questionable result seems to be obtained.

"What particularly bothers us occurs in the hypothetical case of an insurance subsidiary being requested by a state regulatory body to transfer a certain amount from its surplus to its capital shares account. This transfer could apparently have been recommended or ordered for many reasons; however, as a minimum result, it should have the effect of restricting the amount transferred from the payment of dividends. Following this procedure through to its logical conclusion, it seems that the parent company would then create additional earned surplus, through a reduction in its undistributed profits, and presumably would have that much more earned surplus available for dividends on its own stock. In other words, while the subsidiary may have effectively 'frozen' its own surplus, the parent company 'unfreezes,' or at least makes available for dividends, an equivalent amount. This seems to be an illogical result and we would appreciate your thoughts in the matter."

Our Opinion

We completely agree with the conclusion expressed in your letter that it is illogical and inconsistent for the parent company to credit its earned surplus and charge its "Undistributed profits of subsidiaries" account upon the subsidiary's issuance of a stock dividend.

About the only practical suggestion we have is for the parent company to continue to reflect "Undistributed profits of subsidiary accumulated since date of acquisition" without any adjustment of that account for the amount of retained earnings capitalized by the subsidiary in connection with its issuance of a stock dividend. A footnote keyed to the undistributed profits caption might then be used to indicate that a portion of the undistributed profit amounting to $X has been transferred from the subsidiary's retained earnings to its stated capital (or to its capital stock and capital surplus accounts as the case may be) in connection with its issuance of a stock dividend. An alternative presentation on the parent's balance sheet, although more cumbersome, would be:

Undistributed earnings of subsidiary accumulated since date of acquisition –		
Amount included in retained earnings of subsidiary	$ xxx	
Amount(s) transferred to stated capital of subsidiary* pursuant to issuance of stock dividend(s)	xxx	$ xxx

(*or "to capital stock and capital surplus of subsidiary")[1]

Inquiry 357

Propriety or impropriety of holding company's using "undistributed earnings of subsidiary" as stock dividend base

"My problem is in connection with stock dividends payable by a holding company. As you know, most holding companies do not have sufficient retained earnings to pay a stock dividend. The annual amount of dividends received from subsidiaries is, in effect, an amount equal to the annual cash dividend customarily paid by the parent plus the actual expenses of the parent company for the year. This would prohibit the company from paying a stock dividend since management is reluctant to increase the dividend requirement from subsidiaries.

"However, I have seen financial statements of similar corporations in which a stock dividend was paid by capitalizing the necessary amount from 'Retained earnings of subsidiaries less minority interest.'

[1] We are not aware of any discussion of your particular problem in the literature. The discussion under the major heading "Investment Account Adjusted to Changes in Book Value" and especially under the subheading "Treatment of Stock Dividends" at pp. 23.12-14 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) fails to cover your question. However, for a brief discussion of a question which comes very close to the one you raise, see question and answer number 2 at pp. 570-1 of the article "Some Problems Regarding Consolidated and Parent Company Statements" which appeared in the November, 1953 issue of *The Journal of Accountancy*. Personally we believe the view expressed by the minority (q.v.) is the sounder view. But cf. *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) under "Stock Dividends of Subsidiaries" at p. 46.

Since this item does not appear on the company's books in the first instance, it appears to be a novel approach to the problem.

"I would like to know whether you believe this transaction is backed by sound accounting principles and theory. An example of this type of transaction from an actual report, follows:

Excerpt from Surplus Reconciliation:		
Balance		$32,188,013
6% stock dividend of 59,371 shares declared in 1960 from 'Surplus from increase in equity in net assets of subsidiary banks'—at $79.25 a share, approximate market value at November 9, 1960*	$4,705,152	
Less – excess of market over par value*	3,517,732	
Amount transferred to capital stock account equal to the $20 par value of the shares issued	$1,187,420	
Cash dividends paid – $1.75 a share....	1,731,669	
		2,919,089
Balance at December 31, 1960 (see note to balance sheet)		$29,268,924

*In the surplus segregation shown in the note to the accompanying balance sheet $4,705,152 was deducted from 'Surplus from increase in equity in net assets of subsidiary banks' and $3,517,732 was added to 'Capital surplus.'"

Our Opinion

It cannot be stressed too strongly that the propriety of corporate dividends or other distributions is *not* a matter of accounting principles and theory – the conditions and circumstances under which corporate distributions may properly be made and the question as to what constitutes a proper dividend base are governed by state corporation statutes and judicial decisions within the jurisdiction where the corporaiton is organized.[1]

[1] In this connection, see the excellent discussion relating to dividends and surplus at pp. 149-65 of Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957).

We believe payment of a stock dividend out of undistributed earnings of a subsidiary taken up (i.e., recognized) on a parent company's books *might* raise the question in *some* states as to whether the dividend shares so issued are void or voidable and/or whether such shares may be deemed "fully-paid and non-assessable."

For its bearing on the problem raised in your letter, we note that, in discussing the question whether stock dividends constitute income to the recipient stockholder, chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953), par. 7 on p. 50 states that

> . . . many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation (in your case, read "income to the corporate parent stockholder as it accrues to the corporate subsidiary"), and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the *separate entity* concept of corporation accounting.

The question to be faced up to, then, is whether such concept *should* be abandoned in the holding company situation where such company *controls* the dividend policy of the subsidiary company. Paragraph 19 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) takes a rather definite step in this direction when, in discussing "Unconsolidated Subsidiaries in Consolidated Statements," it expresses a *preference* for adjusting

> . . . the investment through income currently to take up the share of the controlling company . . . in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group.

Be this as it may, in states which allow the payment of dividends only out of "realized surplus," query whether undistributed earnings of subsidiaries recognized on a parent company's books would legally be deemed "realized" and a proper dividend base.

We believe the exchange of correspondence which *directly follows,* discusses many if not most of the significant aspects of the question you raise.

INQUIRY: 357

Propriety of parent company's paying cash dividend out of "undistributed earnings of subsidiaries" or subsidiary surplus capitalized pursuant to stock dividend

Initial Inquiry

"As a member of the American Institute of Certified Public Accountants, I would like to have your considered opinion on the question stated below:

"A parent corporation has sixteen subsidiaries which it owns 100 per cent. It is faced with paying dividends to its own stockholders which stock is the only stock held by individual persons. The parent carries its investments in subsidiaries at book value of the subs — that is, by taking up the profits and losses of its subsidiaries each accounting period and crediting a surplus account called 'Accumulated earnings of subsidiaries.'

"The parent has a deficit in its 'own' accumulated earnings account, but it has on its books the account called 'Accumulated earnings of subsidiaries.'

"Disregarding the question of state laws, would it be proper accounting for the parent to pay dividends to its stockholders out of the increment of 'Accumulated earnings of subsidiaries'? I realize that the subsidiaries could declare dividends to the parent and solve the problem that way, but the situation is that the subsidiaries do not have cash available to pay such dividends to the parent, and if it were paid, the parent would have to lend the money to the subs so that they would be able to pay."

Our Opinion

Three good references touching on this question of what constitutes distributable surplus of a parent are the following:

1. Summary of Accounting Affidavits Filed in Cintas v. American Car and Foundry Co. Case.
2. "The American Car and Foundry Decision," by George O. May.
3. In "Some Problems Regarding Consolidated and Parent Company Statements," see question and answer number 18.

(The above discussions appeared in the October 1942, December 1942, and November 1953 issues, respectively, of *The Journal of Accountancy.*)

One general comment: It does not seem to us that one can properly decide whether a corporation may pay a dividend under the circumstances described solely on the basis of "proper accounting," at the same time "disregarding the question of state laws." While accounting concepts may contribute to or affect the law governing corporate distributions, still it is the law governing this particular matter which should be determined before a proper decision on the propriety of the dividend distribution can be reached.

It seems to us it would be unwise to proceed without a legal opinion in this situation especially in view of the fact that the parent's books also reflect an accumulated deficit.

Follow-Up Inquiry

"I would like to impose my problem on you for a little further thought, since we are now looking at it from a different standpoint.

"Corporation A, the parent corporation, is a sales finance company with 90 per cent of its assets in liquid form of cash and notes receivable-installments. Corporation A owns 100 per cent of the stock of eighteen subsidiaries, also in the sales finance and loan business. All eighteen of the subsidiaries borrow money from the parent to carry on their business, since they were originally capitalized for comparatively small amounts of from $25,000 to $50,000.

"Corporation A, the parent, is now faced with paying a cash dividend to its individual stockholders in the approximate amount of $225,000 and at present has accumulated earnings and surplus of only $10,000. We don't want to rob the subsidiaries of their capital, since it is thin enough already, and also if the subsidiaries declared and paid a cash dividend to the parent, the parent would actually have to loan or advance the cash to the subsidiaries in order that they might pay it back to the parent in the form of a cash dividend.

"Due to this situation, it has been proposed that the subsidiaries declare stock dividends and issue more of their capital stock to the parent. The parent company would enter and recognize the subsidiaries' action by increasing its 'Investment-in-subsidiaries' account and offset this with a credit to its 'Surplus' or 'Accumulated earnings,' out of which it would then pay its cash dividends to its individual stockholders.

"Would you please give me your department's opinion of this procedure, and the reasons back of your opinion? I have read chapter 7B of *Accounting Research Bulletin No. 43* and it seems to leave this question up in the air, as to stock dividends issued to a parent corporation by a subsidiary."

Our Final Opinion

You will recall that in our previous letter, we ventured the opinion that one cannot "properly decide whether a corporation may pay a dividend under the circumstances described solely on the basis of 'proper accounting,' at the same time 'disregarding the question of state laws.'" We also stated that "While accounting concepts may contribute to or affect the law governing corporate distributions, still it is the law governing this particular matter which should be determined before a proper decision on the propriety of the dividend distribution can be reached." We believe these statements should be reiterated because, as we see it, the crucial question involved in the situation described appears to be whether, in the state where the parent corporation is organized, *cash* dividends may be paid out of *appraisal* or *revaluation surplus.*

You will note that in the article "Some Problems Regarding Consolidated and Parent Company Statements" which appeared in the November, 1953 issue of *The Journal of Accountancy,* the answer to question 18 at p. 576 stated that "A majority of those replying also expressed themselves to the effect that the accrual of a subsidiary's earnings, as earned, on the books of the parent company is acceptable though not desirable procedure, and should be discouraged."[2]

Regarding the treatment proposed in your latest letter, viz., to have the subsidiaries declare stock dividends and then have the parent company increase its "Investment-in-subsidiaries" account and offset the increase by a credit to "Surplus" or "Accumulated earnings," the latter then to be used for paying cash dividends to the parent's individual stockholders — in our opinion, this treatment would be contrary to generally accepted accounting principles and would serve only to make the parent corporation's legal position more complicated and tenuous. It would be rather inconsistent to capitalize subsidiaries' earned surpluses upon declaring stock dividends thereby assigning such earned surplus to a relatively more "permanent" realm or category of capitalization and then recording such "permanently capitalized" amounts on the parent company's books as part of the parent's realized earnings to be used as a basis for paying out cash dividends.[3]

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[2] It is of interest to note that this *Journal* article was based on a poll of the opinions of the then members of the Institute's Committee on Accounting Procedure.

For some additional authority indicating that a parent's adjustment of the cost of its investment in a subsidiary for increases or decreases in the underlying equity is acceptable from an accounting standpoint, but a treatment considered desirable by only a minority, see Paton and Paton's *Corporation Accounts and Statements* (Macmillan Co., N.Y., 1955) and G. S. Hills' article on "The Law of Accounting" [54 *Col. L. Rev.* 1 (Jan.) and 1049 (Nov.), 1954]. The *Accountants' Handbook* (Ronald Press Co., N.Y., 1943), in the statement at the bottom of p. 1073, implies that "Equity in Profits of Subsidiaries" is not considered to represent surplus available for dividends. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), in discussing "Investments in Subsidiaries" at pp. 290-1, states the ff., viz.: "Investments in subsidiaries for the purpose of control are ordinarily recorded at cost. . . . (They) may be carried at amounts adjusted periodically to reflect underlying net assets of the subsidiaries, but this practice, while having some logical basis, has generally fallen into disuse, and is not recommended. It is not the function of the accounts and statements of the parent to show profits and losses of affiliated enterprises as a whole. The practice of adjusting investment accounts to reflect underlying net assets of subsidiaries is less objectionable when the subsidiaries are primarily domestic operating divisions of the parent."

Subsequent to this exchange of correspondence, *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1962) was published. In the chapter on "Intercorporate Investments," a position contrary to those stated above is expressed, viz.: "Accounting for investments in the voting stocks of other companies on the basis of historical cost is often uninformative and it may be misleading . . . we are of the opinion that, in general, the equity basis of carrying intercorporate investments presents the financial position and results of operations of the companies owning the investments in a more informative and realistic manner than the cost basis."

[3] For authority to the effect that the payment of a stock dividend does *not* result in income to the recipient, see pp. 50-1 of *Accounting Research Bulletin No. 43.* See also *Montgomery* and the *Accountants' Handbook* (*op. cit.* footnote 2) at pp. 148 and 1072, respectively, and question number 2 at pp. 570-1 of the aforementioned article in the November, 1953 *Journal.*

Incidentally, if as stated in your first letter, the "parent carries its investments in subsidiaries at book value of the subs," then there would be no occasion to increase the investment account further upon declaration of a "stock dividend" by the subsidiaries, as proposed in your second letter. The writeup would have already been made.

In stating at the outset of this letter, that the crucial question appears to be whether, in the particular state of incorporation, the parent company may legally pay dividends out of *appraisal* or *revaluation surplus,* we have in mind the thought that an upward restatement of a company's investment account to recognize increases in the underlying equity of a subsidiary in effect gives rise to a revaluation surplus whether such surplus is labeled on the parent's books as "Undistributed earnings of subsidiary" or "Equity in profits of subsidiary" or is given some other designation. We think it fair to regard the credit arising from the writeup of the investment as a "revaluation-type" surplus which could properly be reclassified as earned surplus only when the subsidiary made actual payment of a cash or property dividend to the parent company. The very word "undistributed" connotes that the earnings or increment is literally *unrealized* from the standpoint of the parent company entity.

On the question of the declaration of dividends out of revaluation surplus, an item in Carman G. Blough's column entitled "Payment of Stock Dividends Out of Reappraisal Surplus" (in *The Journal of Accountancy* for March, 1951, pp. 462-4) indicates that some states allow issuance of stock dividends out of appraisal surplus but not cash dividends, that other states completely proscribe any dividends out of appraisal surplus, and that still other states allow payment of any type of dividend out of any type of surplus so long as the declaring corporation is solvent both before and after the dividend. It is our understanding that a number of states have now adopted substantial parts of the *Model Business Corporation Act* (sponsored by American Law Institute and American Bar Association), and from a reading of the latter's section on dividends in conjunction with its definitions of "earned surplus," "capital surplus," "net assets," etc., it would appear that *cash* dividends could not be paid out of surplus arising from appreciation.

If a legal basis cannot be laid for the parent company's paying cash or stock dividends out of revaluation surplus reflected on its books as "Accumulated earnings of subsidiaries," then in the absence of the actual payment of cash or property dividends to the parent by the subsidiaries, it seems to us the few remaining legitimate possibilities for the parent company if it wishes to get cash into the hands of its stockholders, would be either to make a loan of the money to its stockholders, or to effect a distribution of cash by means of a dividend in partial liquidation or in redemption of some of its stock, or by creating a "reduction surplus" by reducing the par value of its authorized capital stock. These latter solutions, of course, may or may not be practicably or legally feasible due to the thin capitalization of the parent, the fact that the state corporation statute bars corporate loans to officers and stockholders, the fact that the parent company has an accumulated deficit, or for tax or other reasons.

Inquiry **358**

Charging stock dividend to consolidated earned surplus where fair value of dividend shares exceeds parent's surplus

"In June, 1962 one of our clients paid a 5 per cent stock dividend under the following circumstances:

"Capital of the corporation at the close of its fiscal year, March 31, 1962 was:

	Consolidated	*Parent Company Only*
Capital stock ($10.00 par value, outstanding 266,410 shares, in treasury 14,765 shares)	$2,664,100	$2,664,100
Surplus:		
Capital	91,300	63,800
Contributed	126,800	
Earned	1,225,500	34,700
Total capital & surplus	$4,107,700	$2,762,600

"The company's stock is publicly-held and is traded over-the-counter. The market value was:

March 31, 1962 (close of fiscal year)	20¾ Bid
April 30, 1962 (date of declaration of stock dividend)	18¼ Bid
May 15, 1962 (record date)	18 Bid
June 1, 1962 (payment date)	17 Bid

"The 5 per cent dividend was paid by issuing 13,100 shares and paying $4,080 for fractional shares not issued.

"This was recorded on the books by the company, by charging earned surplus $135,080:

13,100 shares @ $10.00 par value	$131,000
Cash paid for fractional shares at $18.50 per full share	4,080
	$135,080

resulting in outstanding capital stock of 266,410 shares plus 13,100 shares for a total of 279,510 shares.

"From chapter 7B, *Accounting Research Bulletin No. 43,* it is apparent that the fair market should be charged to earned surplus (with capital stock credited for $131,000 and the balance credited to capital surplus). In so doing, the parent company's earned surplus account (after current year earnings and payment of regular cash dividends) might show a deficit. However, the consolidated earned surplus would probably increase.

"Since earnings and book value are based on the consolidated statements and since only consolidated financial statements are issued to stockholders, would it be proper to charge the excess of market value over par to 'consolidated earned surplus' and credit this excess to 'consolidated capital surplus' [refer to page 206 of *Accounting Trends and Techniques* (AICPA, 1961) – Radio Corporation of America]?

"In view of the drop in market price from the time of declaration of the dividend to the date of payment, would it be proper to use the market value at the payment date?"

Our Opinion

As you are aware, chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953) gives no guidance on the particular question you raise.

Specifically, you ask whether it would "be proper to charge *the excess of market value over par* to 'consolidated earned surplus' and credit this excess to 'consolidated capital surplus'" (*our emphasis*). It seems to us that, in order to remove all doubts, legally or accounting-wise, the proper way to accomplish this would be for the *subsidiary*, by appropriate board resolution, to transfer a portion of its earned surplus equal to the excess of market value over par attributable to the dividend shares issued by the *parent company*, to its (i.e., the subsidiary's) capital stock account. The amount transferred would then become part of the subsidiary's legal or stated capital. Upon consolidation then, i.e., in the process of eliminating the parent company's investment against the underlying net equity, the amount transferred would perforce be reclassified as capital surplus. The problem would thus be resolved, assuming the parent company had at least enough surplus (of any type) on its books to absorb a charge for the total par value of the dividend shares issued. If the parent company had insufficient surplus to cover the total par value, the resulting "deficit" on the parent's books, it seems to us, would technically measure its capital impairment which would be in the nature of *stock discount.*

One rationale that might be acceptable *in a state which allows a corporation to pay stock dividends out of revaluation or appraisal surplus* (unrealized appreciation), would revolve around the contention that the undistributed earned surplus of the subsidiary since date of acquisition (which is combined with the earned surplus of the parent company upon consolidation) is basically, *from the standpoint of the controlling company,* unrealized surplus. Where a parent company takes up the undistributed earnings, and records and separately earmarks the undistributed surplus of an *unconsolidated* subsidiary, it adjusts its investment upward for the unrealized amounts; the only difference in consolidation is that the assets and liabilities of the subsidiary are substituted for the investment.

Chapter 7B of *Accounting Research Bulletin No. 43* is silent on the matter of the date to be used when determining the market value to be ascribed to dividend shares. Accordingly, we personally see no deterrent to the client's capitalizing the stock dividend at market value as of payment date.

Initial Inquiry **359**

Should dividends be paid on treasury stock?

"1. When a corporation has declared a cash dividend and holds treasury stock, is the corporation entitled to receipt of dividends on such treasury stock?

"2. Is a corporation entitled to receive stock dividends on its own treasury stock?"

Our Initial Opinion

The answer to your first question is found in one of the formal accounting rules adopted by the Institute membership and made a part of *Accounting Research Bulletin No. 43* (AICPA, 1953, at p. 12), viz.:

> 4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

In our opinion, for the same corporation to pay and receive such a dividend would be equivalent to "taking money out of one pocket and putting it into another"; from an accounting standpoint it would result in accounting twice for the same income. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 388) states that

> . . . When dividends are paid through a dividend paying agent, they may be paid on treasury stock, but upon receipt these dividends should be applied as a reduction of the amount of dividend distribution and not taken into dividend income.

Relevant to this point, note the view expressed by Paton in his article on the "Balance Sheet" in the 1945 AICPA publication *Contemporary Accounting* (and the additional authority there cited) that "there is no substantive distinction for accounting purposes between authorized shares that have never been issued and such shares which have been issued and subsequently reacquired."

Regarding the second question which you raise, we have, in the past, attempted to research the literature on this point and, at that time, could find no references to the problem. Our own opinion on the question is that a corporation would be entitled to set aside for itself, dividend shares on its own treasury stock. By this means, the corporation would maintain the same ratio of treasury shares to total issued shares after the stock dividend as existed prior to such dividend, and we believe this to be desirable. The same amount of earned surplus per share would be capitalized in connection with the dividend shares set aside in the treasury as in the case of the other dividend shares. The additional number of shares held in treasury would be indicated in the financial statement, and the treasury shares should preferably be shown at cost, to indicate the extent to which earned surplus is restricted on account of the purchase of treasury shares in the first instance.

A case in point is that of American Viscose Company. We understand that in its 1950 annual report, it doubled the number of issued shares and raised the par value from \$14 to \$25 per share. By doubling the number of *issued* rather than just the number of *outstanding* shares, it doubled the number of treasury shares. The treasury shares had the same carrying value before and after the stock dividend.

Follow-Up Inquiry

"This letter is written to take issue with the conclusion which you reached in your answer to question number two.

"In your answer to question number one, you quoted an article by Paton that 'there is no substantive distinction for accounting purposes between authorized shares that have never been issued and such shares which have been issued and subsequently reacquired.' You used this quotation to back up your conclusion, with which I agree, that a corporation is not entitled to a cash dividend on its own treasury stock. Why would not the same quotation rule out the propriety of a stock dividend on treasury stock?

"It is my belief that most stock dividends arise from the fact that part of the retained earnings of the corporation has been invested in such a way that the corporation's officers feel they would be unable to distribute these earnings at any future date without impairing the earning capacity of the corporation or affecting it adversely in some other way. The corporation then declares a stock dividend to give formal notification to the stockholders that part of the retained earnings has been invested in working assets of the corporation and that these earnings are no longer available for the payment of cash dividends.

"Stock, as I believe we will all agree, is evidence of a proprietary interest in a corporation. When a corporation reacquires some of its own stock, it has not obtained a proprietary interest in itself. It has merely reduced its capital, by paying out cash or something else of value, and at the same time reduced the number of outstanding shares which represent the ownership of this reduced amount of capital. This reduced number of shares still own one hundred per cent of the corporation.

"Since the retained earnings of a corporation in reality belong to the owners of the corporation in proportion to the number of shares of stock that they own, how could any portion of these retained earnings be said to belong to the shares of treasury stock, which do not represent any ownership interest? It then follows that, since treasury stock has no interest in the retained earnings, no stock dividends should be declared on treasury stock.

"You also made the statement that by setting aside for itself dividend shares on treasury stock 'the corporation would maintain the same ratio of treasury shares to total issued shares after the stock dividend as existed prior to such dividend.' It is not at all clear to me why the maintenance of such a ratio is necessary or even desirable. Treasury stock is in the same class as authorized but unissued stock in that it does not represent any proprietary interest in the corporation nor is it an asset of the corporation. True, treasury stock could presumably be sold for value, but so could any authorized but unissued stock be sold by merely taking proper corporate action.

"Also, it seems of little value to maintain the ratio of treasury stock to outstanding stock. When the original treasury stock was acquired there probably was no plan to acquire a certain percentage of the outstanding stock. Even so, the next transaction in the corporation's stock, whether issuing new or treasury stock, retiring outstanding or treasury stock, or purchasing more treasury stock, will change this ratio. Therefore, why try to maintain this ratio when a stock dividend is paid?"

Our Final Opinion

This is in response to your letter in which you criticize, in a very constructive and thoughtful manner may we add, the comments which we made in response to the question: Is a corporation entitled to receive stock dividends on its own treasury stock?

Upon re-examining the views we initially expressed on this question, we are inclined to think we were correct in principle but injudicious from the standpoint of not sufficiently qualifying our remarks. Having certain equitable considerations uppermost in mind, we stated the opinion "that a corporation would be entitled to set aside for itself, dividend shares on its own treasury stock. By this means, the corporation would maintain the same ratio of treasury shares to total issued shares after the stock dividend as existed prior to such dividend, and we believe this to be desirable."

A qualification to the above opinion which we now consider most necessary would be to add the phrase "in certain cases" at the end of the above-quoted passage. The cases we have in mind are those in which the stock dividend is large enough to influence the market price of the shares materially and where the original treasury shares were reacquired in the first instance to enable the corporation to purchase property or other assets, to carry out the terms of a stock bonus or employees' stock purchase plan, or to meet the obligations of its stock option contracts. The thought also occurs to us that a corporation by issuing dividend shares to itself, might equitably adjust for the pre-emptive right requirement, in cases where such pre-emptive right has not been expressly waived by charter, or abolished or restricted by statute.

Incidentally, two cases illustrating certain points we have in mind are those of Burlington Mills and of American Metal Co., Ltd. In 1951, the former company's financial statements showed a three for two common stock split with a 50 per cent increase in the number of shares subject to options; in 1952, the latter company's financial statements reflected a 5 per cent stock dividend and the assignment of 7,447 additional shares to treasury. In this latter case, the treasury stock was being held to meet the requirements of a stock option plan.

You state the following: "Since the retained earnings of a corporation in reality belong to the owners of the corporation in proportion to the number of shares of stock that they own, how could any portion of these retained earnings be said to belong to the shares of treasury stock, which do not represent any ownership interest? It then follows that, since treasury stock has no interest in the retained earnings, no stock dividends should be declared on treasury stock."

INQUIRY: 359

While your quoted statements have, let us say, "the ring of truth," we feel they are subject to substantial qualification, and that your *unqualified* conclusion is a non-sequitur. Regarding the matter of the retained earnings "belonging to" the owners of the corporation, one could mention, in passing, the questions of realizability upon liquidation (either of the corporation or of the stockholders' shareholdings), possible intervention of creditors' rights, erosion of retained earnings by subsequent losses, or non-distributability thereof due to permanent capitalization. If one takes the normal case of a solvent corporation, the retained earnings technically "belong to" the shareholders (in the sense of an enforceable claim) only when they are transformed into a corporate *debt* upon formal declaration of a cash or property dividend by the board with notice thereof to the shareholders.

But let us get back to the main issue. While one may grant that treasury shares do "not represent any ownership interest" in the common signification of that term, nevertheless, treasury shares may affect, or be used so as to affect, ownership interests. In this connection, it is important to note that retained earnings are frequently *restricted* to the extent of the cost of treasury shares. Also, the present stockholders' interest in retained earnings may be conditioned by the fact that valuable options are extant, with consequent corporate obligation to honor contractual commitments involving stock options, conversion privileges, stock bonus plans, etc., by the use of treasury shares.

One further point of interest might be mentioned. As a technical matter, dividend resolutions usually require that a dividend be paid to "stockholders of record." Since the name of a corporation holding treasury shares is registered in the corporate transfer books, it appears that the corporation is technically a "stockholder of record." Accordingly, unless a dividend resolution reads that the dividend shall be paid to stockholders of record "exclusive of shares held in the name of the corporation as treasury stock," or unless special instructions are given to the transfer or dividend paying agent not to pay a dividend on treasury shares, then a dividend would be paid on such shares. It is our understanding that, in practice, special instructions are usually issued to agents not to pay cash on the treasury shares. However, it is also our understanding that, where stock dividends are declared and option, bonus, or other similar plans are in effect, it is common practice for agents to issue dividend shares to the treasury for the treasury shares of record.

Incidentally, it is of interest to note that the recently enacted *New York Business Corporation Law* (effective September 1, 1963) contains the following provision in section 511(b), viz.:

> A corporation making a pro rata distribution of authorized but unissued shares to the holders of any class or series of outstanding shares may at its option make an equivalent distribution upon treasury shares of the same class or series, and any shares so distributed shall be treasury shares.

Inquiry **360**

"Split-up effected in the form of a dividend" — capitalization of paid-in surplus

"We enclose a copy of a letter which we sent to the Securities and Exchange Commission requesting an opinion from them as to their attitude and/or regulations.

"In addition to the SEC attitude, we are also concerned with good conventional accounting procedure. As indicated in our letter to the SEC, we have spent considerable time and effort in an attempt to learn the accepted conventional method of reflecting such transaction."

Copy of Letter to SEC

"We would appreciate having the SEC's attitude or opinion on a corporation's distribution of par value stock in a situation where such distribution of par value stock is made out of capital surplus.

"As an example of such a situation, we present the following facts:

Corporation's capital structure is as follows:	
Paid-in surplus — resulting from sums paid for capital stock in excess of par value	$400,000
Capital stock — 100,000 shares outstanding, par value $1.00	100,000
Earned surplus — resulting from the accumulation of earnings and undistributed profits over several years	100,000
Total	$600,000

"In order to create a reduced selling price for the corporation's stock and effect a greater and more widely-held stock situation which would result in more effective marketability of the stock, the corporate management desires to split the existing stock by issuing three shares of unissued stock for each share now in the hands of the public. It is the desire of the corporate management to make the distribution by charging at par value ($1.00 per share) the 'Paid-in surplus' of the company. This may be effected in accordance with the procedures, and within the definitions of stock split-up, as we find them in *Accounting Research Bulletin No. 43* (chapter 7B, par. 2).

"Under Florida statutes, section 608.52, 'dividends may be paid to stockholders from the net earnings or from the surplus of assets over liabilities including the capital of the corporation, but not otherwise. When the directors shall so determine, dividends shall be paid in stock.' The corporation attorney interpreted this to mean, that under Florida law, there are no restrictions as to the issuance of stock in a split-up as hereinabove outlined with a charge to 'Paid-in surplus' for the par value of the additional shares issued.

"It is our desire to obtain the SEC attitude or an official opinion concerning this transaction.

"We have spent considerable time in an attempt to find some regulation, ruling, or opinion representing the U.S. Government's attitude in such a situation. We have not been successful. We trust, therefore, you will consider our problem and advise."

Our Opinion

In view of par. 15, p. 53 of *Accounting Research Bulletin No. 43* (AICPA, 1953) and the corporation attorney's opinion that "under Florida law, there are no restrictions as to the issuance of stock in a split-up as . . . outlined with a charge to 'Paid-in surplus' for the par value of the additional shares issued," we fail to see that there is any substantial question as to the accounting propriety of charging "Paid-in surplus" with the par value of the shares issued.

A "split-up effected in the form of a dividend" (see par. 11, p. 52, of *A.R.B. No. 43*) is involved here, rather than a "true" stock split-up which in addition to a multiplication of issued shares, ordinarily would involve a reduction in the par or stated value of such shares. Apart from the motivation of the stock split-up in question, viz., effecting a reduction in the unit market price of shares of the class issued and thus obtaining wider distribution and improved marketability of the shares, the principal effect of the transaction is formally to increase by $300,000 the legal or stated capital of the corporation.

The accounting rule (possibly of tax origin) that distributions are deemed to be made first out of earned surplus, then out of paid-in surplus, etc., does not, in our opinion, apply to the case in question.

When acting in good faith and with business purpose, a board of directors, we believe, has plenary authority to increase its legal or stated capital in the manner indicated in your letter. In this connection, it is of interest to note the following provisions of the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with American Bar Association): Section 19 dealing with "Determination of Amount of Stated Capital" states, in part, that

> The stated capital of a corporation may be increased from time to time by resolution of the board of directors directing that all or a part of the surplus of the corporation be transferred to stated capital. The board of directors may direct that the amount of the surplus so transferred shall be deemed to be stated capital in respect of any designated class of shares.

"Surplus" is defined in the *Act* to mean "the excess of the net assets of a corporation over its stated capital." Section 40 dealing with "Dividends" states, in part, that

> Dividends may be declared and paid in cash or property *only out of the unreserved and unrestricted earned surplus* of the corporation, except as otherwise provided . . . (and that) Dividends may be declared and paid in its own authorized but unissued shares out of *any surplus* of the corporation upon the following conditions: (1) If a dividend is payable in its own shares having a par value, . . . there shall be transferred to stated capital at the time such dividend is paid an amount of *surplus* equal to the aggregate par value of the shares to be issued as a dividend. . . . (*our emphasis*)

It seems to us the following passages from Finney and Miller's *Principles of Accounting – Intermediate* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958, at pp. 138 and 139-40) are also relevant to the question you raise:

> A good many writers on accounting have said that dividends should be paid from earned surplus only. If they mean that

dividends from other sources are illegal, the statement is subject to contradiction; if an action is permitted by law, accountants can interpose no effective "should not" deterrent. However, since it is quite possible that stockholders may be uninformed as to the law and may assume that all dividends received represent distributions of retained earnings, the ethics of business management may properly require that, if a dividend is paid from any source other than retained earnings, the stockholders be informed of the source.

Stock dividends. The principal question which accountants face in connection with stock dividends is the determination of the amount or amounts which should be transferred from certain stockholders' equity accounts to other stockholders' equity accounts. The laws differ in their requirements. In some cases, stock dividends are intended merely to convert paid-in surplus into capital stock; such dividends have no effect on retained earnings, and no accounting problems arise in recording them.

Inquiry **361**

Retroactive treatment of 2 for 1 split-up and three 10 per cent stock dividends as a split-up

"We would appreciate your opinion as to the proper method of handling stock dividends by a client of ours for whom we are preparing an SEC Registration Statement.

"Three 10 per cent stock dividends have been recorded upon the books as follows:

Date	Number of Shares	Par Value	Transfer from Earned Surplus to Capital Stock
11/16/59	16,669 shares	$5.00	$ 83,345
11/15/60	18,336 shares	5.00	91,680
11/15/61	40,340 shares	2.50*	100,850

*Par value reduced from $5.00 to $2.50 in 1961

"Counsel advised the client that the transfer of an amount equal to par value from earned surplus to capital stock met the legal requirements.

"The stock is not listed but is traded over-the-counter. The following prices have been secured from brokers, after payment of the stock dividends:

11/27/59	$30.00 bid
11/28/60	36.00 bid
11/28/61	25-27 bid

"Book value of the stock at December 31, 1959, was $16.27 per share and at December 30, 1960, $16.45 per share.

"Assuming a stockholder owned 1,000 shares before the first stock dividend, the following changes would have taken place:

Original shares		1,000
11/16/59	10% dividend	100
		1,100
11/15/60	10% dividend	110
		1,210
In 1961, shares received as result of reduction of par value from $5.00 to $2.50		1,210
		2,420
11/15/61	10% dividend	242
Shares now held		2,662

"In your opinion, could this 166 per cent increase in the number of shares in a two-year period be considered as a stock split? In such case, the transfer of the par value from earned surplus would then be sufficient.

"If not, what additional amount should be transferred to capital surplus? We feel that the quoted prices are excessive and that book value would be a more proper basis if an additional transfer should be made.

"In addition to the capital stock account the corporation has a paid-in or capital surplus of $397,500. Would the sum of these two accounts divided by the number of shares outstanding before the stock dividends were paid be equivalent to the minimum amount that should be capitalized?"

INQUIRY: **361**

Our Opinion

After closely perusing chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953), and relevant pages in the New York Stock Exchange's *Company Manual* (applicable to listed companies),[1] we find it difficult to develop any rationale which would justify treatment of the 166 per cent increase in number of shares over a two-year period as a stock split and yet be consistent with the foregoing policy statements – unless perchance during the periods when the dividend shares were issued, the client can possibly qualify as a "closely-held company" despite the fact that its stock is traded over-the-counter (see par. 12, p. 52, of *Accounting Research Bulletin No. 43*).

It goes without saying it is unnecessary to capitalize any earned surplus for the additional shares issued in connection with the 100 per cent stock split involving reduction of the par value from \$5.00 to \$2.50 per share.

We believe one *might* seriously question the necessity for capitalizing additional amounts of earned surplus *retroactively* to recognize the "fair value" of the dividend shares issued, on the following grounds:

1. If the *primary* purpose of the requirement set forth in par. 10 of chapter 7B of *Bulletin No. 43* (*op.cit.*) is precautionary rather than punitive, i.e., if such requirement is designed to prevent *present stockholders* (i.e., those holding stock at the time of the dividend declarations) from being misled as to the nature of the distribution being made to them, then the fact that par. 10 was not followed when the dividend shares in question were issued would appear to be "water over the dam" from the standpoint of both present and prospective stockholders.

2. The amounts of "net income for the year" reflected in the three years' income statements required to be included in the S-1 Registration Statement and reflected in the five-year earnings summary required to be included in the Prospectus, would be unaffected by the manner of recording the 1959, 1960, and 1961 stock dividends or the 1961 stock split. Furthermore, it is questionable whether a *prospective* investor who may read the balance sheets (as of dates within

[1] See pp. A-235-236 and A-255-259 therein dealing with "Stock Dividends" and "Stock Split-Ups."

90 days and one year prior to filing) included in the Registration Statement and/or Prospectus, would be influenced one way or another if the retroactive adjustment is or is not made. It does not appear that the retroactive accounting adjustment as such (any amounts of earned surplus retroactively capitalized will lodge in capital surplus) can effectively preclude the payment of dividends to the extent of the amount capitalized *if,* as is frequently the case, the corporation is in a jurisdiction where dividends may legally be declared out of capital surplus.

Notwithstanding the foregoing, we believe the CPA would find it difficult if not impossible to express an opinion that the balance sheet "presents fairly . . . in accordance with generally accepted accounting principles" – the provisions of par. 10, chapter 7B, of *A.R.B. No. 43* being what they are.

At this distance, it is difficult for us to know whether "book value" would be more representative of the "fair value" of the shares than the quoted bid prices. "Book value," of course, is not necessarily representative of "fair value." All we can state on this point is that many fair-value bases have been used for the purpose in question, e.g., last sale or bid price, or the mean between bid and asked price most proximate and prior to the day preceding the board's action; also, we believe an average of sales prices within a range of dates prior to the board's action has been used.

Regarding the question raised in the last paragraph of your letter, it is relevant to note that while *Accounting Research Bulletin No. 11, Corporate Accounting for Ordinary Stock Dividends* (AICPA, 1941; now superseded by chapter 7B) provided that "the amount per share in the capital-stock and capital-surplus accounts combined before the issuance of the stock dividend, should be maintained upon . . . issuance (of the stock dividend) by capitalization of at least a like amount of earned surplus for each dividend share," that *Bulletin* nevertheless went on to state that ". . . where . . . fair market value per share is substantially in excess of the amount per share of the combined capital-stock and capital-surplus accounts before the stock dividend, (the board) should fix the number of dividend shares so that the amount charged to earned surplus per share will have a reasonable relationship to such fair market value."

Albeit not in accordance with chapter 7B, it appears that one reasonable alternative would be to capitalize earned surplus to the extent of the company's accumulated earnings *attributable to the years in which the stock dividends were declared.* Such a procedure would be tantamount to more or less permanently capitalizing the buildup in fixed assets and working capital resulting from the company's policy of refraining from distributing its current earnings in those years in the form of cash dividends.

It is a moot question whether the SEC would deem an adjustment on such basis acceptable. It is possible that they might feel differently on the question whether the stock dividends and stock split may be viewed retrospectively as a split.

DIVIDENDS RECEIVED

Inquiry **362**

Is stock dividend distributed in form of treasury stock, income to recipient?

"In connection with a study[1] which I am currently conducting, I have been attempting (unsuccessfully) to determine the position of the AICPA in regard to 'stock dividends' distributed in the form of treasury stock. I would appreciate it very much if you would let me know whether you consider this type of distribution as being similar to 'ordinary' stock dividends, or whether you might consider it as income to the recipient.

"Income tax regulations take the position that stock dividends, regardless of the form in which they are distributed, are not income. Judicial decisions on fiduciary matters have considered the distribution of treasury shares to be income, under certain circumstances. Despite the rulings of these two authorities, apparently no formal basis has been established upon which this question may be solved, in accordance with 'good accounting theory.' "

[1] The study referred to was published subsequent to this exchange of correspondence. See *The Stock Dividend,* by M. Richard Sussman (Michigan Business Studies, vol. XV, no. 5, University of Michigan School of Business Administration, Ann Arbor, 1962) esp. pp. 38-9.

Our Opinion

The specific question which you raise was not discussed in chapter 7B of *Accounting Research Bulletin No. 43* (AICPA, 1953); chapter 7B, as you probably know, deals with "Stock Dividends and Stock Split-Ups." Nor has any official publication of the Institute dealt with your specific question elsewhere, as far as we know.

In our opinion, however, the basic conclusions of par. 6 of chapter 7B (at p. 50 of *A.R.B. No. 43*), viz., ". . . until there is a distribution, division, or severance of corporate assets, the shareholder has no income. . . . (and) In the case of a stock dividend . . . , there is no distribution, division or severance of corporate assets," are valid whether the dividend shares distributed represent shares previously held as treasury stock or shares previously authorized but unissued.

Of course, if treasury shares are purchased for a consideration, there is a severance of corporate assets at the time the treasury shares are acquired. Furthermore, if such treasury shares are acquired from the shareholders pro rata (assuming earned surplus to be available), we would then go along with the tax view that the "distribution in partial redemption of stock" is income *at that time* to the recipient shareholders, i.e., the distribution is "essentially equivalent to a dividend." It seems to us a partial pro rata redemption effects essentially the same changes in both corporate and shareholder financial status as an outright cash or property dividend, i.e., the net assets of the corporation are reduced and the shareholders realize cash or property without any change in their proportionate interest in the remaining corporate net assets.

However, in the case where a corporation purchases the entire stock of one of its several stockholders and carries such stock as treasury stock, it remains to say that while the retiring stockholder may break even or realize a gain or loss depending on whether the consideration paid by the corporation (severance of assets) equals, or is greater or less than, the original capital contribution of the retiring stockholder, nevertheless, the remaining stockholders realize no income at that time because there is no severance of assets vis-à-vis them. Note in this case, that the proportionate respective interests of the remaining stockholders increase, while the book values of their respective interests may remain the same, or be greater or less than they were before the transaction, depending on the amount of the consideration paid for the shares of the retiring shareholder, i.e., whether the corporation paid the latter the book value of his shares or an amount less or greater than the book value of his shares. In any event, upon subsequent distribution of the treasury shares as a stock dividend to the remaining stockholders, the latter, in our opinion, do not realize income since there is no severance of corporate assets with respect to the recipients.

Inquiry 363

Optional dividends, in cash or stock — does controlling interest's election to take stock result in income?

"One of the larger transportation carriers subject to our accounting regulations is faced with an accounting problem having elected by option to receive a stock dividend from a majority-owned subsidiary corporation under the following circumstances:

"Company A offered an option to its common stockholders of receiving either a cash dividend of $4 for each share of stock owned or a stock dividend of one share of common stock for each twenty shares of common stock owned. The minority stockholders, owning 20 per cent of the outstanding common stock elected the cash dividend and the controlling stockholder, Company B, elected to receive the stock dividend. Does the majority stockholder, Company B, account for the stock dividend as income, or as a regular stock dividend? *Accounting Research Bulletin No. 43* does not specifically state whether or not a 'stock' dividend received under these circumstances must be regarded as income.

"I would appreciate your opinion and comments on this subject."

Our Opinion

As mentioned in your letter, *Accounting Research Bulletin No. 43* (AICPA, 1953) does not discuss the proper accounting for so-called *optional* dividends.

However, *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at pp. 149-50 and 406-07) which is the only reference we have seen even briefly discussing the matter, "see(s) no good reason why the privilege of taking a certain amount of cash in lieu of stock should make it proper or desirable to consider that the unaccepted offer of cash gives the stock dividend a status different than that of an ordinary stock dividend."

On the other hand, as we understand it, under the Internal Revenue Code, a stock dividend is *non-taxable* unless the distribution of stock may be deemed to be in lieu of a distribution of money or other property, i.e., is *taxable* if the stockholder could elect to receive money or other property. The tax viewpoint is, of course, understandable from an administrative and enforcement standpoint, viz.: just as the Internal Revenue Service will not countenance the taxpayer's current avoidance of tax by *assigning* income to a third party (unless "the tree as well as the fruit" is assigned or transferred), so also in the factual circumstance of an optional dividend, the IRS apparently will not allow the taxpayer to avoid current tax incidence by *postponing* the recognition or realization of income. If such is the tax view, it seems to boil down to the contention that income should be recognized if the accounting entity has the power and right to effect its realization but nevertheless elects to forego current realization thereof. Carried to its logical conclusion, this view would support "arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder," arguments which from a reading of par's 6 and 7 at p. 50 of *A.R.B. No. 43* are apparently given little if any weight in the case of an ordinary stock dividend.

In support of recognition of income to the parent company in the case in question, one might contend with some cogency that since a parent and subsidiary are involved, the parent is not "*being given* a choice" [*Montgomery's Auditing* language (*our emphasis*) at p. 149], but on the contrary, through its control of the subsidiary, has itself initiated and determined the dividend policy.

There is, of course, the further argument to be reckoned with, viz., that since the election to receive shares while the minority interest takes cash gives the parent company an interest different from that represented by its former holdings, the parent is thereby deemed to have received income.

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For whatever value it may have, our personal opinion is that the foregoing points in favor of recognition of income to the parent, should be given relatively little recognition or weight, and for the following reasons:

1. If we let the accomplished fact speak for itself, it seems clear that the "optional dividend" represents a cash dividend to the minority stockholders and a stock dividend to the controlling stockholder, Company B. *Accounting Research Bulletin No. 43* (par. 6, p. 50) takes the position with respect to the recipient of an ordinary stock dividend, that "until there is a distribution, division, or severance of corporate assets, the shareholder has no income." We believe this rationale should also be applied in determining the proper accounting treatment of the receipt of the dividend shares by Company B, irrespective of the fact that, by electing to take stock, Company B has an interest in the subsidiary different from that represented by its former holdings. While the cash aspect of the optional dividend may be looked upon as in effect a liquidating or a "dilution" payment to the minority interest, we do not feel that such distribution has as its necessary counterpart, the recognition of income to the parent company.

2. It should also be stressed that the dividend policy initiated by the parent company together with its subsequent election to take shares, has required the capitalization of a portion of the subsidiary's surplus. Thus, it appears that the possibility of actual realization of the subsidiary's resources to the extent of the amount of subsidiary surplus capitalized, has been made more remote, if anything.

We should emphasize that the foregoing remarks have been made solely from the standpoint of *parent company accounting*, not from the standpoint of consolidated statements. In determining the effects, if any, of the optional dividend upon consolidated statements, we believe par's 18 and 19 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) may be relevant. See also questions 2, 5, and 18, and answers thereto, in the article "Some Problems Regarding Consolidated and Parent Company Statements" which appeared at pp. 570-6 of *The Journal of Accountancy* for November, 1953.

Inquiry **364**

du Pont divestiture of General Motors stock — recipient's accounting for shares received

"On June 8, 1962, a corporate client received General Motors shares from E. I. du Pont de Nemours as the initial distribution by the latter company of its holdings in General Motors stock.

"According to a ruling issued by the Internal Revenue Service, individual stockholders of E. I. du Pont, for income tax purposes, will treat the General Motors shares received as a return of capital at the fair market value. Corporate stockholders will determine their tax on this initial distribution based on du Pont's cost basis of $.87514 for each share of General Motors stock received.

"My corporate client is of the opinion that the General Motors stock should be recorded in the books at $.87514 per share and dividend income recognized in that amount.

"It appears to me that the distribution by E. I. du Pont of its holdings in General Motors stock is a dividend-in-kind and should be recorded at its fair market value with the offsetting credit to dividend income.

"Your opinion is requested as to the proper accounting treatment of the General Motors shares; and should deferred taxes be considered?"

Our Opinion

The following passage from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 149) is quite relevant to the question you raise, viz.:

> Dividends of shares of stock of one company received as the result of ownership of shares of another company, commonly termed "in kind" dividends, represent the receipt of property and are tantamount to the receipt of cash dividends. Accordingly, they should be credited to income at their fair market value, provided that they have been paid from accumulated earnings of the paying company. If these dividends are not paid from accumulated earnings, the cost of the shares on which the dividends are received is ordinarily apportioned between the original shares and

the shares received as a dividend on the basis of their relative fair market values. When the shares are received as a dividend pursuant to a plan of liquidation or divestment, such as a "spin-off" of a subsidiary, an allocation of cost is usually made.

The foregoing indicates two treatments acceptable under specified circumstances, one of which is the treatment for which you express a preference. A third treatment to be considered, of course, is that based on the ruling issued by the Internal Revenue Service. However, we also note that still a fourth treatment may be employed for liquidating dividends or distributions in partial liquidation, namely, accounting for the fair value of the dividends received as a return of capital investment (same as tax treatment to be employed by individual stockholders of E. I. du Pont).[1]

Just in case you have not previously observed it, on the June 30, 1962 interim statements of du Pont, you will note that the property dividend was charged in part to "Paid-In," and in part to "Revaluation," Surplus.[2]

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[1] See relevant pp. 5.26 ("Dividends"); 13.16-17 ("Return of Invested Capital"); 22.27-8 ("Valuation of Property Dividends" and "Liquidating Dividends"); and 22.33-4 ("Paid-In 'Surplus' as a Dividend Base" and "Revaluation 'Surplus' as Dividend Base"), in the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956).

[2] A footnote to the statements reads as follows:

"C. Investment in General Motors Corporation common stock. Final judgment entered March 1, 1962 in the U.S. District Court in Chicago ordered complete divestiture by February 28, 1965 of the company's entire investment in General Motors Corporation common stock, then consisting of 63,000,000 shares.

"On May 31, 1962, the Board of Directors authorized a distribution of General Motors common stock payable July 9, 1962 to stockholders of record June 8, 1962 at the rate of one-half share of General Motors stock for each share of du Pont common stock – equivalent to 22,991,492 General Motors shares. The balance sheet at June 30, 1962 reflects this distribution as if it had been completed at that date by a reduction of $462,128,989 in the carrying value of the General Motors shares. Corresponding to the reduction in the carrying value of these shares is a reduction at June 30, 1962 in Paid-in Surplus of $21,694,964, representing the original cost of the shares distributed, and in Surplus Arising From Revaluation of Security Investments of $440,434,025, representing accumulated additions to the carrying value of the shares distributed arising from previous revaluations of this investment.

"The $804,171,011 carrying value of the remaining 40,008,508 share investment in General Motors Corporation reflects accumulated additions of $693,244,217 which result from a practice followed since 1925 of revaluing the investment in General Motors Corporation common stock annually to an amount which closely corresponds to the equity indicated by the consolidated balance sheet of General Motors Corporation at December 31 of the preceding year."

We should also state in passing that none of the Institute's official Accounting Research Bulletins deal with the question of the proper accounting treatment to be accorded divestiture or liquidating distributions-in-kind.

The first method mentioned by *Montgomery* (*op.cit.supra*) recognizes income immediately, of course, to the extent of the fair value of the property received. The second method mentioned by *Montgomery* would recognize neither profit or loss nor return of capital upon receipt of the property "dividend." On the other hand, the tax treatment for the corporate recipient of the GM stock would recognize income which is only nominal in amount when contrasted with the fair value of the property received. The fourth method mentioned above is essentially a cost-recovery method which would result in the current recognition of income only in a case where the fair value of property received exceeds the cost of the investment on which the property "dividend" is based.

In our opinion, a key question here is whether, in accounting for cash or property dividends, the treatment by the recipient (corporate or individual investor) should be affected or controlled by the *purpose and source* of the dividend payment, i.e., should differ, depending upon which surplus or capital accounts of the declaring corporation are used to absorb the distribution or "dividend" charge.

Perhaps another more specific way of putting the question here, might be: In a situation involving the divestiture of stock representing a controlling interest in another company, i.e., a "spin-off" situation where, after distribution of the stock in question, the recipients now hold direct stock investments in two corporations rather than, as before, a direct investment in one corporation and an indirect investment in another — *is* such a situation, from the standpoint of the realization principle, an event which requires revenue recognition? Personally, we feel the answer should be "no," whether the individual recipient presently intends to hold the GM shares received as an investment or immediately converts such shares to cash (any subsequent sale, of course, would be an occasion for recognizing gain or loss). We are inclined to conclude in favor of the second treatment described in the *Montgomery* passage above, viz.: apportionment of cost of original shares between original shares and shares received as a "dividend" in partial liquidation, on the basis of relative fair market values.

This having been said, we nevertheless believe it would be acceptable in the particular case under discussion to follow the tax treatment for book and financial statement purposes, i.e., recognizing dividend income in the amount of $.87514 per share. The difference in over-all representations in the statements depending on whether the cost-allocation or cost-recovery treatment *or* the tax treatment was followed would be relatively immaterial. Only a relatively nominal amount of dividend income stemming from the divestiture would be reflected in the income statement. With the same treatment being used for both book and tax purposes, no question of tax allocation arises, of course.

If you nevertheless conclude in favor of reflecting dividend income in terms of the fair market value of shares received, we believe tax allocation would then be required. Thus, in addition to the provision for the tax currently payable [15 per cent (after 85 per cent dividends-received credit) *times* number of GM shares received *times* $.87514 per share *times* applicable corporate tax rate], you would also have to provide for and reflect a deferred liability for income taxes in an amount determined by multiplying the difference between the $.87514 per share tax basis and $48 per share fair market value on July 9 by the normal corporate tax rate applicable to capital gains which in turn would be multiplied by the number of GM shares received.

Inquiry **365**

Trust accounting for stock dividends distributable to income beneficiaries under terms of will

"My first question has to do with correct accounting procedure for purposes of an account of proceedings for an executor. Testator's will was admitted to probate November 26, 1957, in the Surrogate's Court of New York County, State of New York. According to the will, all dividends received in the form of stock were to be considered as wholly income and were to be distributed to the income beneficiaries. My query is: Will it be sufficient merely to note the receipt of these stock dividends in the income account, or is it necessary to assign a dollar value to them? If the latter procedure is recommended, what is/are the accepted method(s) for assigning this dollar value?

"My second question has to do with the same broad category. In winding up an estate which consists primarily of securities which are to be distributed in accordance with certain stipulated percentages, are these percentages applied to the market value of the securities on the date of distribution or are they applied to the values of securities as they are carried in the inventory of assets?"

Our Opinion

Taking your second question first, the following statement at p. 2335 of Prentice-Hall, Inc.'s *Wills, Estates, and Trusts* service indicates an authoritative answer, viz.: "For the purpose of distribution, estate assets are taken at their value as of the date of distribution." (*Idem,* see cases cited.)

Regarding your first question, we have been singularly unsuccessful in finding any specific discussion or example of the *accounting entry* made under the circumstances described.[1] In our opinion, it would be important to determine here whether stock dividends which under the terms of the will are attributable to the income beneficiaries and which accrue to such beneficiaries prior to the time when the trustee takes possession of the trust assets, must ultimately be distributed in kind or whether the executor may or must convert such dividend shares to cash prior to distribution. If ultimately distributable to income beneficiaries in kind, all that would appear to be necessary on the part of the executor would be a notation in his income-asset and income-accountability accounts as to the number of described shares

[1] In attempting to determine whether the more common practice is merely to make notation of the receipt of the stock dividends attributable to income beneficiaries without assignment of dollar value thereto, *or* to record such dividends as income attributable to income beneficiaries at an assigned dollar value, we rather carefully perused the following to no avail: Prentice-Hall, Inc.'s *Wills, Estates, and Trusts* service; *Uniform Principal and Income Act; Accountants' Handbook* (Ronald Press Co., N.Y., 1956, section 26 on "Fiduciary Accounting"); *Wills, Executors, and Trustees,* by Grange, Staub, Blackford, and Blattmachr (Ronald Press Co., N.Y., 1950); *Estate Administration and Accounting,* by Dodge and Sullivan (Clark Boardman Co., Ltd., N.Y., 1940, with Supp.); *CPA Review Manual* (ed. by Miller, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1956, discussion of "Estates and Trusts" at p. 472 *et seq.*); and Loring's *A Trustee's Handbook* (Farr revision, Little, Brown & Co., Boston, 1962). These represent just about all the authoritative references in this area which we would ordinarily consult.

held for ultimate distribution. On the other hand, if the executor is required to distribute in cash (and this appears to be the general rule or requirement unless the will or a statute requires otherwise, or a beneficiary has consented or petitioned to have distribution made to him in kind — see p. 2327 of Prentice-Hall, Inc.'s *Wills, Estates, and Trusts*), the equitable rule would seem to be that the executor is accountable to the income beneficiaries only for the net dollar amount received at date of conversion of the dividend shares into cash. This assumes that such shares are converted to cash within a reasonable period after the executor's receipt of the dividend shares. Upon conversion in ordinary course, then, it would appear proper for the executor to record an income asset and income accountability in the amount of the net proceeds received.

Inquiry **366**

Treatment of "capital gain dividends" and gains on sales of securities by fiduciary administering maintenance trust funds of cemetery

"I am enclosing photo copy of a Trust Agreement[1] between my client, a cemetery corporation, and the local bank, as trustee.

"There is a question in regard to the responsibility of the trustee in the disbursing of funds to the cemetery company which all parties desire cleared up so that a mutual understanding may be had for the future.

"The trust consists of approximately $27,000 invested in the Boston Fund, Wellington Fund and George Putnam Fund.

"At present, the above investment companies have been instructed to reinvest the capital gains dividends received each year.

"The questions are:

"1. Are the capital gains dividends to be considered as income of the trust and available for maintenance of the cemetery, or are they

[1] Not reprinted here.

to be considered as appreciation of capital and, therefore, part of the trust fund?

"2. Is the gain on the sale of securities purchased from contributions to the trust, considered as 'other income' under paragraph 4 of this agreement and thus available for maintenance of the cemetery, or would this profit be considered as appreciation of capital and thereby become part of the trust fund?"

Our Opinion

Regarding your first question, perhaps we should state at the outset that the legal aspects of the questions you present are considerable, and that a categorical response to them is not possible. Two diametrically opposite answers may be observed by a perusal of the *Uniform Principal and Income Act,* and the *Restatement of the Law of Trusts.* When, as in the instant case, the instrument itself is silent as to the procedure to be followed by the trustee, one must look to the law for interpretation of the intent of the makers of the trust agreement. Of course, legal counsel should be sought for aid in this interpretation and the application of any pertinent statutes thereto.

There are strong arguments that may be advanced in support of either side for the treatment of "capital gains" dividends, i.e., as income or as an increase in equity (or fund principal). Section 5 of the *Uniform Principal and Income Act,* which we understand is in effect in your state, would apparently require that the capital gain dividends be treated as income. In favor of this treatment, one may reasonably contend that the dividend is made from the distributing corporation's accumulated realized earnings, and is not a liquidating dividend (payments specifically made out of legal capital as part of a formal policy of retrenchment) or a return of capital made out of paid-in surplus.[2]

[2] This type of question has been referred to the Technical Information Service before, and both the questions and replies in two instances later appeared in Carman G. Blough's column in *The Journal of Accountancy* (February, 1950, at pp. 165-7; and August, 1953, at pp. 220-1). The items were entitled, respectively: "Endowment Fund's Treatment of 'Capital Gain' Dividends from Investment Trust" and "Treatment of 'Capital Gain Dividends' by Fiduciary Shareholders." There is also an excellent discussion of the problem in "Capital Gain Dividends – Should They Be Allocated to Income or Principal?", by W. Putney (*Trusts and Estates,* Fiduciary Publishers, Inc., N.Y., January, 1956, at pp. 22-4).

However, when one (a) views the investment trust as an investing *agent* of the trustee-bank, (b) regards the capital gains made by the investment trust as in effect *capital gains made for the account of* the trust administered by the bank (to the extent that the interest of the latter trust appears), and (c) thereupon follows what appears to be the majority rule regarding a trust's treatment of capital gains as an accretion to principal (see answer to your second question which follows) – then it is not difficult to construe the capital gain dividends as an increase in trust fund principal.

As for your second question, i.e., the treatment of the gain (or loss) on the sale of securities owned by the trust, this would generally be regarded as a transaction affecting fund "principal" or "corpus."[3]

[3] In support of this conclusion, see *College and University Business Administration* (vol. 1, American Council on Education, Washington, D.C., 1952) pp. 91-2, and *A Trustee's Handbook,* by Loring (Farr revision, Little, Brown & Co., Boston, 1962) pp. 247-8.

Chapter 6

Surplus and Deficit; and Presentation, Adjustments, or Appropriations Thereof

Inquiry 367

Regarding the "equalization account" of regulated open-end investment companies

"We have a question on which we would appreciate help in regard to 'Equalization Debits and Credits' of a regulated investment company. In *Case Studies in Auditing Procedure No. 6* (AICPA, 1947) covering 'A Management-Investment Company of the Open-End Type,' there is an explanation of Equalization Debits and Credits included on page 12 in the center paragraph. We understand the purpose of this Equalization Debit or Credit, but are not clear as to whether or not this applies to ordinary income only or to both ordinary income and net realized gain on investments.

"We will appreciate information as to whether or not realized gain or loss on investments is taken into account when figuring the amount to be set aside in the Equalization Debit or Credit account, upon the sale or repurchase of stock in a regulated investment company of the open-end type."

Our Opinion

There is a relative dearth of references dealing with accounting and auditing for mutual funds or regulated open-end investment companies and only a few references even briefly discussing the so-called "equalization account." However, we contacted an Institute member who unquestionably qualifies as an authority on investment trusts, and he informs us that open-end investment companies "definitely do not equalize gains or losses on sales of securities" from portfolio.

Of course, it almost goes without saying, realized gains or losses on investments during the period to date are included when computing net asset value. As we understand it, net asset value comprises the following elements, viz.: capital stock and paid-in surplus, unrealized depreciation or appreciation of portfolio, realized loss or gain on investments during the period, undistributed income at beginning of period, and income for the current period plus or minus the balance in the equalization account minus any dividends paid during the period.

For the additional help or guidance they may provide, we suggest your perusal of, say, the *Annual Report of Massachusetts Investors Trust;* R. H. Galpin's article on "Investment Company Accounting" (*The N.Y. CPA* for December, 1950) under the heading "Calculation of Net Asset Values"; a brief discussion of "Equalization" in H. I. Prankard's chapter on "Accounting for Investment Companies" (in *Contemporary Accounting,* AICPA, 1945); and pp. 28-9 in W. A. Robertson's article on "Investment Companies" (*The Arthur Young Journal* for January, 1954) briefly referring to "the policy of 'equalizing' dividend payments by allocating to undistributed income the amounts applicable to net income included in the price of capital shares issued and repurchased." These references indicate rather clearly that undistributed *income* has primary reference to dividend and interest sources of income, while realized gains or losses on investments are deemed accretions or decretions of *principal.*

INQUIRY: 367

Inquiry **368**

"Forgiveness" of debt owed by distributor, coupled with settlement of latter's claim against manufacturer for breach of contract

"Would you please give us your opinion on the following accounting treatment:

"A distributor had a contract to distribute products for a certain manufacturer. In 1959, the manufacturer improperly canceled the contract. At that time, the distributor owed the manufacturer $70,000. The manufacturer sued the distributor for the $70,000. The distributor filed a counterclaim against the manufacturer for abrogation of the contract. In 1960, both suits were settled with the result that the distributor received a forgiveness of its $70,000 debt and also received $100,000 in settlement of its claim against the manufacturer. Thus for 1960, the distributor has income from this source of $170,000. The distributor has an operating loss before taxes of $30,000 in 1960.

"*Accounting Research Bulletin No. 43* states that an item may be credited to earned surplus 'which in the aggregate is material in relation to the company's net income and is clearly not identifiable with or does not result from the usual or typical business operations of the period.' Consequently, it is proposed that the item of $170,000 reduced by the Federal income taxes attributed thereto be credited to earned surplus in 1960."

Our Opinion

Based on the facts stated in your letter, we believe it would be proper to credit the $170,000, reduced by attributable taxes, to earned surplus. In our opinion, the nature of the item is such that it comes within the purview of the language quoted in your letter from par. 11, chapter 8, of *Accounting Research Bulletin No. 43* (AICPA, 1953).

Incidentally, the question whether debt forgiveness should be recognized as revenue or treated as an increment to capital (credit to capital surplus) is unsettled (see *Accountants' Handbook,* Ronald Press Co., N.Y., 1956, at pp. 5.8-9). In some circumstances, the question also arises whether canceled debt should be applied so as to reduce certain assets on the ground that such application is a belated recognition of losses inherent in such assets but not heretofore recognized. However, even if one were to concede that "forgiven debt" should *ordinarily* be credited to capital surplus (and we do so concede), we do not believe such treatment should obtain under the particular circumstances described in your letter. The "forgiveness" here is merely a means of *effecting* the judgment on the counterclaim, i.e., by setting off the debt against the money judgment that the distributor would otherwise have obtained. In other words, the $170,000 presumably measures the distributor's "loss of profits" on the unilaterally canceled contract.

Inquiry 369

A. Capitalization of portion of earned surplus without concurrent issuance of shares

B. Failure to capitalize overhead attributable to constructed facilities

"We have encountered a situation in a Class A water company on which we solicit your opinion.

"During the year under examination, the board of directors authorized the transfer of an amount from earned surplus to capital stock. This was termed a transfer. Nothing was said in the minutes about its being any type of dividend. The only type of stock outstanding is no-par common.

"We realize that the transfer did not affect the book value of the stock. However, we have been unable to find any information on such a situation, and solicit your opinion as to whether or not it is in accordance with generally accepted accounting principles.

"We find in the same company that procedures of the regulatory uniform system providing for the capitalization of certain overhead expenses have not been followed. We are not far enough along with the examination to determine the amount of overhead expenses that should have been capitalized for 1960, but we do know that a considerable amount of construction was done during the year. Please give us your opinion as to whether or not we should take an exception in our report to this procedure, i.e., if we cannot get the company to agree to capitalize the proper amount of overhead expenses. In case the client should agree to the change, we believe that we should comment on the inconsistency in our report. What is your opinion about this?"

Our Opinion

Regarding your first question, in our opinion, a stock dividend is not a sine qua non of a corporation's making a transfer from earned surplus to capital stock account. Although we have not undertaken to determine what the Louisiana state corporation code or statute provides in this respect, the better corporation statutes would permit a board of directors to increase legal or stated capital by transferring (capitalizing) amounts from surplus. For example, note the following provision from section 19 of the *Model Business Corporation Act* (American Law Institute in collaboration with American Bar Association, revised, 1953), viz.:

> The stated capital of a corporation may be increased from time to time by resolution of the board of directors directing that all or a part of the surplus of the corporation be transferred to stated capital. The board of directors may direct that the amount of the surplus so transferred shall be deemed to be stated capital in respect of any designated class of shares.

Thus, the initial situation you describe, i.e., the authorized transfer from earned surplus to capital stock is not, in our opinion, amenable to, or controlled by, generally accepted accounting principles. In our view, if the opinion of counsel bears out the fact that the transfer is legally effectuated, then the accounts should reflect the fact of the transfer. If the company does not disclose in a footnote the fact that the board has "permanently dedicated" a portion of earned surplus to stated capital, we personally believe that, because such transactions are relatively infrequent or unusual, the CPA should make "necessary explanation" in his report of the reason why the capital stock account reflects an amount which exceeds the total stated value of no-par stock issued and outstanding.

Regarding the questions raised in the last paragraph of your letter, we believe that if the company does not capitalize the proper amount of overhead expenses (either from the standpoint of generally accepted accounting principles or from the standpoint of the regulatory uniform system requirements), then the CPA definitely should take exception if material amounts are involved.

In case the client company should now agree to capitalize the proper amount of overhead expenses for the current and future years, we believe you should comment on the inconsistency in your opinion, and also state your approval of the change to the generally accepted procedure.

It may be impracticable or impossible to measure the amount of overhead charged off immediately rather than capitalized in prior years. However, if it *is* practicable to determine or to estimate on some reasonable basis the effect on the current financial statements of failure to capitalize overhead in past years, we believe retroactive adjustment of fixed asset, depreciation allowance, and earned surplus accounts should be made therefor. If retroactive adjustment is not made, then in the paragraph of your report in which you mention the change in the company's practice of treating overhead, you should mention the net effect on fixed assets and on earned surplus of the failure to capitalize overhead in prior years and also the approximate effect on the current year's operating income. It seems to us you would not be required continuously for a number of years to qualify your opinion because of this improper past practice in the treatment of overhead, i.e., to qualify your opinion with respect to distortive financial effects resulting from an improper practice employed prior to the year which you are engaged to audit, unless very material amounts are involved.

Inquiry **370**

Acceptability of board's action in transferring earned surplus to capital stock

"I would like to have your opinion on the following problem:

"In the 1960 annual report of the Public Service Company of .... the following statement is made:

> On December 31, 1960 the earned surplus account was reduced and the common capital stock account was increased by $15,000,000 representing that portion of retained earnings which the company believes may safely be dedicated to permanent capital at this time.

"I recently wrote the company about this, as I am a common stockholder, asking for their reason, and raising the question that such an entry might tend to conceal available earned surplus for dividends and other purposes, and received a reply from the Chairman of the Board, a copy of which is appended.

"In your opinion, is such a procedure common, advisable, or justified by generally accepted accounting principles?"

LETTER FROM CHAIRMAN OF BOARD

"Dear Mr. ....

"You raise a rather interesting, and certainly valid, point in your letter regarding our annual report for 1960.

"At December 31, 1960 the company had about completed a period of heavy construction expenditures (the gross additions for the preceding ten years amounted to $392,624,000.), reserves were adequate, and the earning ability was reasonably established. Generally, dividends are paid out of current earnings, and the cash flow from such earnings, rather than out of accumulated surplus, which would raise the question of public financing to pay such dividends.

"Under all of these circumstances, it was thought advisable and proper to make the transfer to permanent capital."

Our Opinion

In our opinion, matters such as the declaration or non-declaration of dividends and the transfer of a portion of retained earnings to the capital stock account (with or without a concomitant issuance of dividend shares) are discretionary with the board of directors. Of course, any action by the board must be undertaken in good faith and must not be arbitrary or capricious; judicially determined criteria as well as provisions and standards prescribed by state corporation or other statutes are the ultimate frame of reference within which board actions are tested.

Regarding your statement that you "raised the question that such an entry might tend to conceal available earned surplus for dividends, . . ." in our opinion, if the transfer from earned surplus to capital stock is accomplished by proper resolution in appropriate circumstances, such board action results in a formal dedication of the amount of earned surplus in question to legal or stated capital. As a consequence, such amount may never again be returned to earned surplus for regular accounting purposes. It *is* possible that the amount could later become part of capital surplus, i.e., a "reduction surplus" arising out of a reduction of the par or stated value of the corporation's stock and as such, it could form part of the dividend base if in the state of incorporation, dividends may legally be paid out of capital surplus. To add one more complication respecting the status of the amount of earned surplus transferred to the capital stock account: it is our understanding that the amount, although legally transferred in accordance with board action as allowed by state statutes, would not be effectively transferred out of "earnings and profits" for Federal income tax purposes.

As far as we know, the procedure described in your letter is not frequently employed; its advisability is mainly a matter within the discretion of the board. One might query why we should question this particular procedure or entry when we would readily accept the identical entry if it were accompanied by the issuance of dividend shares. Personally, we do not believe one should attempt to "justify" or "not justify" this particular procedure in terms of generally accepted accounting principles. If the board's action is right and proper, the accounting should give effect to the resulting transaction. Of course, if a board passed a resolution to transfer a material portion of earned surplus, say, to a fixed asset account or to a depreciation allowance account, then accounting principles would definitely enter the picture in connection with a determination whether the entry required by the board's action represented a bona fide adjustment to correct past underdepreciation *or* resulted in the creation of a "hidden" or "secret" reserve.[1]

[1] For their bearing on certain aspects of the question raised, see Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954) at pp. 539-40; as well as section 19 of the *Model Business Corporation Act* (American Law Institute in collaboration with American Bar Association, revised, 1953).

Inquiry **371**

Stated capital in excess of total par value

"I have received a statement of The Chicago Daily News, Inc., which has an item on the balance sheet described as follows:

Common stock, $1 par value; authorized 750,000 shares;
issued 485,893 shares $5,765,893

"Will you point out under what situations entry or entries could be created in which the figure shown of $5,765,893 will be appropriate in lieu of $485,893, which would be the result of $1 par value stock being sold and crediting the capital stock account with par value and the excess to a paid-in surplus account.

"You will note from the enclosed statement that there is a paid-in surplus account of $2,000,000."

Our Opinion

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, at p. 422) states that "The amount assigned to capital stock, regardless of class, may include amounts paid in excess of par or stated value."

Where a corporation issues shares having a par value, usually the consideration received therefor is deemed to constitute legal or stated capital only to the extent of the aggregate par value of such shares. Accordingly, such aggregate par value is ordinarily reflected as the amount of capital stock issued and outstanding in the balance sheet, and the excess of total consideration received over aggregate par value of the issued shares is reflected as paid-in surplus.

However, the par value of shares issued generally represents only the *minimum required* legal or stated capital; a board of directors may by resolution require that all or a part of the excess of consideration paid over par value be deemed stated capital. For that matter, a board, either with or without a stock dividend, may by proper action transfer all or a portion of surplus to stated capital.

Thus, in the case cited in your letter, it may be that the board chose to regard all or a portion of capital contributed in excess of the par value of issued shares, as part of legal or stated capital; or the excess of stated capital over par value of issued shares may have originated in a transfer from surplus.[1]

Inquiry 372

Presentation and reconciliation of consolidated retained earnings after majority owner sells small portion of its shares in subsidiary

"As a member of the AICPA, I should appreciate receiving a reply to the questions raised below based upon the following situation:

THE FACTS

"Parent Company (P) uses the cost basis to account for its investment in Subsidiary S, 81 per cent owned at December 31, 1960. On January 20, 1961, P reduces its ownership of S to 79 per cent by selling shares on the market and makes a profit of $14,000 on the sale. S has Capital Surplus as well as Retained Earnings.

QUESTIONS

"1. Is P entitled to include in Consolidated Retained Earnings 81 per cent of the earnings of S to January 20, 1961, or should it include only 79 per cent?

"2. Since P's share of S's Retained Earnings at December 31, 1960 is reduced to 79 per cent (and assuming no further decreases to December 31, 1961), should P show an adjustment for the reduction of its share of S's Retained Earnings in the Consolidated Statement of Retained Earnings at December 31, 1961, or is there any accounting

[1] In connection with the foregoing remarks, see the definition of legal or stated capital in Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957) at pp. 140-1; see also section 19 of the *Model Business Corporation Act* (American Law Institute collaborating with the American Bar Association, revised, 1953) dealing with "Determination of Amount of Stated Capital."

justification for netting the reduction in Consolidated Retained Earnings vs. the profit on the sale of S stock? I imagine the Consolidated Statement of Capital Surplus will have to show an adjustment.

"3. As I see it, the profit on the sale of S stock goes into Retained Earnings and not Capital Surplus as it is not the result of a transaction in the parent's own stock. Is this correct?"

Our Opinion

We believe the item entitled "Treatment of Gain to Parent on Sale of Stock of Subsidiary and 'Loss' to Consolidation" (appearing in Carman G. Blough's column, "Current Accounting Problems," July, 1947 issue of *The Journal of Accountancy* at pp. 65-6) should be helpful in focusing on the questions raised in your letter. Note especially the last paragraph beginning at the bottom of page 65. To restate these principles or conclusions, fitting them to the case in question, they might appear as follows: 81 per cent of surplus earned by subsidiary since date of parent's acquiring control would be combined with earned surplus of the parent in consolidated balance sheets until date of sale of a portion of the parent's investment, i.e., until the time when the 81 per cent investment in subsidiary is reduced to 79 per cent. After the 2-percentage-point portion of the parent's investment is sold, 2 per cent of the surplus earned by subsidiary since date parent acquired control would be eliminated from any statements of consolidated earned surplus subsequently issued by parent. It seems to us a corollary of the latter proposition is that 21 per cent of the post-acquisition earnings of the subsidiary should thenceforth be included in the minority interest as well as 21 per cent of the pre-acquisition earnings of the subsidiary. Similarly, we believe 21 per cent of the subsidiary's capital surplus at the 12/31/61 balance-sheet date should be included as part of the minority interest reflected on the consolidated balance sheet.

In the light of the foregoing, we believe the reconciliation of consolidated retained earnings at 12/31/61 would appear as follows:

Balance at the beginning of the year (comprised of parent's retained earnings and 81% of subsidiary's post-acquisition earnings	$ xxxxx
Add: Consolidated net income for the year 1961 [comprised of parent's net income for the year (including $14,000 profit on sale of stock of subsidiary) and 79% of subsidiary's net profits for the year 1961, exclusive of any intercompany profits]	xxx
	$ xxxxx
Deduct: 2/81 of post-acquisition earnings of subsidiary which were included in consolidated retained earnings balance at beginning of year	xxx
Balance at the end of the year (comprised of parent's retained earnings at year-end, and 79% of subsidiary's post-acquisition earnings through December 31, 1961)	$ xxxxx

With regard to question number 3 in your letter, we believe the following excerpt from the reference mentioned at the outset of this reply, is relevant:

> The parent does, however, upon sale of its investment in the subsidiary, realize a gain to be taken into earned surplus either directly or through income just as it would record the gain on any asset sold.[1]

[1] We believe Karrenbrock and Simons' *Advanced Accounting — Comprehensive Volume* (South-Western Publishing Co., New Rochelle, N.Y., 1955, pp. 457-61) supports the conclusions expressed above and should be helpful in further clarifying the problem.

Inquiry 373

Necessity or usefulness of furnishing reconciliation of surplus changes

"We would like to be informed whether, in connection with a balance-sheet audit, an independent accountant should take a strong position for showing summarized surplus changes in the balance sheet.

"Some clients (principally closely-held corporations) request, for example, that only one amount be shown under the 'Earned Surplus' caption. It has been the practice of this firm in the past to show surplus changes in these instances but a few textbook authorities appear to condone the showing of the net surplus without accounting for changes during the year."

Our Opinion

In our opinion, the term "financial statements" commonly embraces balance sheet, income statement, *and* a surplus or "net worth" reconciliation in some form. This point has never been belabored to any extent in the Institute's official bulletins or statements. However, it is relevant to note the following excerpt from *Statements on Auditing Procedure No. 28, Special Reports* (AICPA, 1957, par. 5, p. 29),* viz.:

> . . . While no precise definition of the term financial statements has been made by the committee, it is quite clear that the term as used in the pamphlet *Generally Accepted Auditing Standards,* as well as in *Statement on Auditing Procedure No. 27, Long-Form Reports,* refers to financial statements which purport to show financial position and results of operations; such financial statements usually consist of a balance sheet and statements of income, retained earnings, and capital.

The discussion under the heading "The Balance Sheet as Related to Financial Position" in *Montgomery's Auditing* (Ronald Press Co.,

* Cf. *Statements on Auditing Procedure No.* 33 (AICPA, 1963) at pp. 56-7 (par's 3 and 4), p. 61 (par. 22), and pp. 90-1 (par's 9 and 10). The latter was published subsequent to this exchange of correspondence.

N.Y., 1957, at pp. 101-02), appears to support the view that an independent accountant should urge his client to furnish third parties with a statement of income and surplus reconciliation in some form, as well as with a balance sheet, the thought being that a balance sheet may not be too useful from an analytical standpoint unless accompanied by the other financial statements which will enable a determination of *trends*. However, the profession has never officially taken the position that all three customary statements *must* be furnished,[1] or that if a balance sheet only is furnished, it necessarily must include a surplus reconciliation on the face of the statement. Be this as it may, if a balance sheet is to be the sole financial statement presented, we personally believe you should strongly urge the client to reflect summarized surplus changes therein.

Incidentally, with the increasing emphasis being placed upon the income statement in recent years, it seems to us there is a trend away from use of the term "balance-sheet audit." It is customary now to speak of an "examination of the balance sheet and related statements of income and surplus." For some relevant observations on this point, see the item "Extensive Audit Work Necessary to Express Opinion Limited to Balance Sheet" (in Carman G. Blough's column at p. 138 of January, 1951 issue of *The Journal of Accountancy*).

Inquiry 374

Retirement of old preferred and common stock and replacement with new Class A and B common—what surplus may be charged?

"Our firm was recently engaged to perform an audit in conjunction with a proposed public offering of securities by our client. This proposal has now been accepted by the SEC and other authorities. Now, in the process of issuing certain securities, there has arisen a question in accounting theory on which none of our partners have been able to agree. They have authorized me to write you, outlining the problem, and request your opinion.

[1] See *S.A.P. No.* 33 (AICPA, 1963) at pp. 56-7 (par. 3).

"As of the audit date, the capital structure of X Company was as follows:

CAPITAL STOCK	
Preferred stock – par value $7.50 per share; issued and outstanding 18,293 shares	$137,197.50
Common stock – par value $1 per share; issued and outstanding 5,000 shares	5,000.00
Total capital stock	$142,197.50
PAID-IN SURPLUS	44,765.36
RETAINED EARNINGS	43,887.13
Total shareholders' equity	$230,849.99

"So as to provide all necessary information, the content of the Paid-In Surplus account is analyzed as follows:

Reduction in par value of 1,660 shares of issued preferred stock from $100 per share to $7.50 per share	$153,550.00
Reduction in par value of 5,000 shares of issued common stock from $10 per share to $1 per share	45,000.00
	$198,550.00
Less: Write-off of accumulated deficit at August 31, 1956	195,370.08
Balance after quasi- reorganization	$ 3,179.92
Excess of issue price of 16,633 shares of preferred stock over the par value of $124,747.50	41,585.44
Balance at recent audit date	$ 44,765.36

"Pursuant to the offering circular, the X Company plans to retire its existing preferred and common stock and replace it with Class A common stock and Class B common stock – this new stock is described thusly:

Class A common – authorized 30,000 shares at a par value of $7.50 per share
Class B common – authorized 300,000 shares at a par value of $1.00 per share

"Prior to the actual public sale of stock, the old stock was retired according to the following plan:

a. The X Company issued 5,265 shares of Class A common stock and 13,028 shares of Class B common stock in exchange for the 18,293 shares of previously outstanding preferred shares.
b. The X Company issued 35,000 shares of Class B common stock in exchange for 5,000 shares of previously outstanding common shares.

"The parties involved are in agreement as to the accounting treatment of the transaction outlined above in 'a.' — viz.:

Preferred stock	$137,197.50	
Class A Common		$39,487.50
Class B Common		13,028.00
Paid-In Surplus		84,682.00

"However, the transaction outlined in 'b.' above, has caused a difference of opinion among the parties involved. The question basically resolves to this:

> Should the $30,000 excess of the par value of the Class B common being issued over the par value of the previously outstanding common shares be charged against Paid-In Surplus or Retained Earnings?

"Proponents of the Paid-In Surplus charge believe that the transaction is of a capital nature and should be handled thusly.

"Proponents of the other theory feel that since only a very minor portion of the Paid-In Surplus arose from the sale of common stock, the charge should be made against Retained Earnings."

Our Opinion

Although we have searched many authoritative reference sources, the accounting literature offers little, if any, guidance in answering your question. In our opinion, there is no single controlling accounting principle which, in the circumstances of this case, requires that the $30,000 (excess of the par value of the Class B common over the par value of the previously outstanding common shares) be charged either to Paid-In Surplus or to Retained Earnings. We do not believe there is any accounting deterrent to making the charge to either or both of the surplus accounts. However, in view of the fact that previously contributed capital has been used to absorb an accumulated operating deficit of $195,370 as recently as three years ago, we would be strongly inclined toward a retained earnings charge. Incidentally, if the Retained Earnings account shown at the beginning of your letter is not dated from the effective date of the quasi-reorganization or readjustment for financial presentation purposes, we believe such dating is required.[1]

In considering the question raised in your letter, assuming an Illinois corporation is involved, no little weight should be given to certain of the provisions of section 17 of the *Illinois Business Corporation Act.* The latter section is *patterned after section 17* of the *Model Business Corporation Act* (revised, 1953, American Law Institute collaborating with American Bar Association). However, we note that certain key language appearing in section 17 which bears on your problem (exchange of par value shares for a different number and class of par value shares) significantly differs as between the *Model* and *Illinois* Acts. It appears that the last paragraph of section 17 of the *Model Act* would allow any surplus transferred to stated capital upon the exchange of old for new par value shares to be deemed a part of the consideration for the issuance of the new shares. It should be noted that the first paragraph of section 17 requires that par value shares be issued for a consideration not less than their par value. Query whether the changes made in the language of the last paragraph of section 17 of the *Illinois Business Corporation Act* ("same aggregate par value") precludes recognition of a portion of surplus as "adequate" and/or as "sufficient" consideration for the stock issued in exchange. In other words, it seems to us the opinion of competent counsel should be obtained as to whether there is any possible element of stock discount involved here. We raise this question because our curiosity is naturally aroused as to why the specific language

[1] The writeoff of the deficit had been made in August, 1956; this reply was written in November, 1959. See *Accounting Research Bulletin No. 43* (AICPA, 1953) at p. 45 *et seq.*, and *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus* (AICPA, 1956).

changes were made in section 17 of the *Illinois Act* in taking it over from the *Model Act.*[2]

Incidentally, the only discussion of a fact situation close to that described in your letter which we were able to find in an authoritative accounting text is the following from p. 120 of Finney and Miller's *Principles of Accounting – Intermediate* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958), viz.:

> If a company changing from a par to a no-par basis has any surplus accounts resulting either from operations or from transactions in the stock which is being converted to a no-par basis, the balances of these accounts should not be transferred, in whole or in part, to capital stock unless the directors authorize such a transfer entry or take some formal action which is equivalent to authorizing such an entry. Any such transfers usually would be made first from any premium on stock or other paid-in surplus accounts resulting from transactions in the par value shares which are being converted to a no-par basis; the remainder should be transferred from Retained Earnings. To illustrate a formal board action equivalent to the authorization of a transfer from surplus to capital stock and the related entries, assume that a company has 1,000 shares of common outstanding with a par value of $100,000 and surplus accounts as follows:

Premium on common stock	$25,000
Retained earnings	40,000

> Assume, also, that the par value shares are called in and that 3,000 shares of no-par common stock are issued with a stated value of $50 per share. This would mean a declaration of $150,000 as stated capital. The entry for the conversion would be:

Common stock	100,000	
Premium on common stock	25,000	
Retained earnings	25,000	
Common stock		150,000

[2] It is of interest to note the following provision of section 504(g) of the *New York Business Corporation Law* which became effective September 1, 1963, viz.: "If outstanding shares are converted into new shares or exchanged for new shares, the consideration for the new shares is the sum of (a) the stated capital then represented by the shares so exchanged or converted, (b) any additional consideration received by the corporation for the new shares, any unallocated stated capital which is thereupon allocated to the new shares and (d) *any surplus* transferred to stated capital in respect of the new shares." (*our emphasis*)

Inquiry 375

Practice of segregating general fund surplus in balance sheets of municipalities

"Recently a copy of the *1959 Annual Report of the City of Philadelphia* was received. This was not the audit report but was a 'popular' version. In this report, the surplus in the General Fund was divided into three sections. The first section was the exact amount of the inventory. The second section was the exact amount of the net receivables. The third section, which was the balance of the surplus, was labeled 'Available for Appropriations.'

"One of the cities that I audit has requested that I make this same presentation in my audit report. The purpose appears to be the restriction on the part of the City Council as to the expense of the ensuing year's appropriation from surplus. Is this a proper procedure to be followed in an audit report? If the answer is yes, is the method of determining the amount available for appropriation correct?"

Our Opinion

We were able to obtain a copy of the *1959 Annual Report of the City of Philadelphia* to note the presentation of the General Fund surplus as described in the first paragraph of your letter. It appears that the rationale underlying the earmarking of portions of surplus equal to the respective amounts of inventories and net receivables, is to present a balance of surplus "Available for Appropriations" the amount of which represents net liquid resources or net assets unencumbered and immediately available or realizable. The inventory amount represents so-called "sunk costs" and the net receivables are prospectively but not immediately realizable.

Municipal Accounting and Auditing (National Committee on Governmental Accounting, MFOA of the U.S. and Canada, Chicago, 1951) at pp. 209-10 may help somewhat to clarify the question you raise. You will note the statement that the surplus account should be divided to show portions applicable to inventories, *et al.* The following statement also appears at p. 28 of that reference:

> The excess of assets over liabilities represents the surplus of the fund. If the General Fund has no surplus reserves, such, for

> example, as a reserve for inventories, then the excess represents unappropriated surplus. If, on the other hand, the General Fund has surplus reserves, then unappropriated surplus is represented by the excess of assets over liabilities, and surplus reserves.

Tenner's *Municipal and Governmental Accounting* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 3rd edition, at p. 56) is also pertinent on this point.

Incidentally, in a pamphlet entitled *Typical Financial Statement for California Cities* (published by League of California Cities and California Society of CPAs, September, 1958), we note items such as "Taxes Receivable" ($30,000) and "Accounts Receivable" ($8,000) in the General Fund balance sheet. The General Fund surplus is earmarked or segregated into the following accounts: "Reserve for Encumbrances," "Reserve for Taxes Receivable" ($30,000), "Tax Interim Reserve," and "Fund Balance."

Further, on page one of the *Annual Financial Report of the City of Hollywood, Florida* (for period October 1, 1958 to September 30, 1959), we note that there is a multiple segregation of surplus in the General Fund.

The foregoing, it seems to us, add up to affirmative answers to the questions raised in your letter.

Inquiry 376

Descriptive terminology for "fund balance" of municipality

"In connection with our audit of a municipality, a question has arisen concerning the use of the term 'Unappropriated Surplus' in financial statements. We are aware of the misunderstandings that may result from the use of this term, but have been unable to decide upon a more suitable and acceptable designation for the excess of assets of a fund over its liabilities and reserves. An objection to the use of a term containing the word 'surplus,' frequently voiced by municipal administrators, is that it implies to the general public that the municipality has accumulated surplus funds as a result of excessive taxation.

"We feel that the designation 'Fund Balance' would be acceptable but would prefer a more descriptive and meaningful term. We note that the AICPA's own comparative balance sheet in its recent annual report contained an item designated 'Income retained for working capital.' Do you have any suggestions or recommendations on this subject? If there are any recent developments or Institute decisions on the above matter we would appreciate hearing of them."

Our Opinion

We believe the following excerpt from Morey's *Municipal Accounting* (John Wiley & Sons, Inc., N.Y., 1942, pp. 39-40) is generally relevant to your problem:

> As each fund is a separate financial unit, each fund has its own surplus or deficit. In the case of revenue funds, this surplus is defined as "unappropriated surplus." In the case of other funds, different titles are needed to describe properly the excess of resources over obligations. There is no one figure of surplus or net worth in a municipality. The surplus of each fund at all times must be shown distinct and separate. In addition, as has been indicated, any equity which is represented by fixed or non-expendable assets should be shown separately from that which is represented by current or expendable assets.

Perhaps you may be able to adapt to your needs, one or more of the following designations which we have gleaned from a perusal of a great number of financial statements of municipalities and of non-profit organizations:

1. Balance
2. Unappropriated Balance
3. Budgeted but Unexpended Balance
4. Fund Balance
5. Unappropriated Fund Balance
6. Balance of Funds
7. Balance of Funds:
   Allocated or Appropriated
   Unappropriated
8. Unexpended Balances of Funds

9. Unexpended Balance of Funds Available for Previously Budgeted Projects
10. Balance of Tax Revenues Available for Previously Budgeted Projects
11. Balance of Tax Revenues Available for Budgeted but Uncompleted Projects
12. Balance of Tax Revenues Available for Uncompleted Projects Budgeted for 1958
13. Funds Unappropriated
14. Unappropriated Reserve Funds
15. Fund Capital
16. Fund Equity
17. Municipal Equity
18. Excess of Fund Assets over Fund Liabilities and Reserves

In your letter you state that you have been unable to decide upon a designation more suitable and acceptable than the term "Unappropriated Surplus" to describe "the excess of assets of a fund over its liabilities and reserves." In our opinion, the latter words might well be "the more suitable and acceptable designation" for which you are searching. See No. 18 above. Perhaps such designation could be tied in with a footnote which would succinctly get across the point that a substantial part of the excess is to be used in carrying out projects officially budgeted for the fiscal period being reported upon but as yet uncompleted.

Inquiry 377

Disclosure of capital surplus arising from reorganization under Chapter 11 of Bankruptcy Act

"Information is requested as to the proper handling of the following situation:

"A year and a half ago our client was a wholly-owned subsidiary and went through a reorganization under Chapter 11 along with the parent corporation. Shortly after the Chapter 11, one of the former stockholders acquired all of the stock of the subsidiary and is now operating the business. On financial statements of his business, we showed in the capital section the amount of the capital surplus arising from the reorganization under Chapter 11, and we labeled it exactly that. In other words, we called it 'capital surplus arising from reorganization under Chapter 11.' The client is now financially sound and is troubled by the reference to Chapter 11 in all of the balance sheets prepared by us. This reference has raised questions in the minds of suppliers and national organizations desiring to purchase the product. Our question is: How long do we have to continue labeling this capital surplus as 'capital surplus arising from the reorganization under Chapter 11.'?"

Our Opinion

Initially, we should point out that none of the Institute's official publications or bulletins deal specifically with the question you raise, viz., the designation to be given capital surplus arising upon a composition or arrangement with creditors, i.e., a scaling down of liabilities, under Chapter 11 of the *Bankruptcy Act.*

To some extent, it may be said that chapter 7A of *Accounting Research Bulletin No. 43* (AICPA, 1953) which deals with "Quasi-Reorganization or Corporate Readjustment," provides an analogue in its requirement (par. 10, p. 47) that

> After such a readjustment. . . . A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

See also *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus* (AICPA, 1956).

In trying to reach a reasonable decision on the question you raise, one might also wish to give some consideration to the SEC's disclosure requirements in connection with quasi-reorganizations. The SEC's *Accounting Series Release No. 15,* states that after a restatement of surplus, certain disclosures (regarding the total amount of deficit and charges made to capital surplus in the course of a quasi-reorganization) be made "until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least three)...."

This having been said, perhaps we should state our own personal view of the question you raise. In our opinion, the rule of informative disclosure would require that the salient facts respecting a legal reorganization be mentioned in the first balance sheet prepared for the subsidiary following the reorganization, on the ground that it is necessary to provide an historical record in the financial statements of the subsidiary, of the fact of the occurrence and significance of the Chapter 11 reorganization. However, this having been done, we would be inclined to draw the line on continuing disclosure. In reaching this conclusion, we are most mindful of the general desirability of a corporation's clearly disclosing the *sources* of its capital. Nevertheless, we have given greater weight to other considerations in the instant case, viz.: the fact that the client is now financially sound; the fact that the present account designation "has raised questions in the minds of suppliers and national organizations desiring to purchase the product"; and in this connection, the fact that in discussing "Adequacy of Informative Disclosures," the publication *Generally Accepted Auditing Standards* (AICPA, 1954) states in part, at p. 53,* as follows:

> ...What constitutes material information requiring disclosure in, or in connection with, financial statements is for the auditor to determine in the best exercise of his judgment....Disclosure should not be considered to require the publicizing of certain kinds of information that would be detrimental to the company or its stockholders.

Finally, we believe considerable weight should be given to the *public policy* underlying the arrangement under Chapter 11 of the *Bankruptcy Act.* As we understand it, the legislative intent in providing for an arrangement was to enable an insolvent company to effect a compromise settlement with its unsecured creditors, to enable the debtor company, freed from its financial burdens, to make a fresh start and *resume its normal status and activities.* Your letter contains evidence that *continuing* disclosure of the Chapter 11 involvement counters the public policy, and frustrates the company's ability to resume its normal status and activities.

* Cf. *Statements on Auditing Procedure No. 33* (AICPA, 1963) at pp. 54-5 (par. 3).

Inquiry 378

Balance-sheet placement or presentation of deficit account

"Would you please advise us as to the proper placement of a 'Deficit' account on a corporation's balance sheet?"

Our Opinion

Kohler's *A Dictionary for Accountants* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1957, at p. 161) defines "deficit" and "deficit account" as follows:

> *deficit*: 1. The amount by which the paid-in capital of a business is impaired; the amount by which the total assets of a business fall short of the sum of its *liabilities* (1) and paid-in capital or proprietary investment: sometimes referred to as "negative" earned surplus, or earned-surplus deficit.
> 2. The ledger account or balance-sheet heading for such an amount.
>
> *deficit account*: A ledger account for a deficit; an earned-surplus account with a debit balance.

Since a deficit measures the amount by which the paid-in capital of a business is impaired, in our opinion, the proper placement of a deficit in a balance sheet is in the capital or "net worth" section in order that *direct* comparison of paid-in capital and deficit amounts can *readily* be made. The generally accepted presentation, we believe, would be to reflect the capital stock issued and outstanding, add thereto any capital or paid-in surplus, and from the sum of such contributed capital, deduct the deficit, with the net result extended to the margin. The net amount may appropriately be described as "Excess of Paid-In Capital over Deficit," or when applicable, "Excess of Deficit over Paid-In Capital."

Regarding the situation to which this latter caption refers, see the item entitled "Financial Presentation When Deficit Exceeds Capitalization" which appeared in Carman G. Blough's column at pp. 203-05 of the August, 1954 issue of *The Journal of Accountancy*.

Inquiry 379

Propriety of reflecting deficit both before and after "appraisal amortization"; defining "unrestricted surplus" for purpose of Texas or Model Business Corporation Act

"We need your advice as to the accounting treatment of 'goodwill' under the following circumstances:

"1. A sole proprietorship was incorporated in a tax-free transaction on December 30, 1955.

"2. At that time, the net book value, at cost, of assets traded for stock was $63,051.15.

"3. An appraisal report was made by an appraisal company resulting in an increase in value of the tangible assets to a total of $135,469.14.

"4. Common stock at $1 par value was issued for the assets of the sole proprietorship in the amount of $135,000.

"5. This tangible asset appraisal increase (for $71,948.85) has been placed on the books and is being depreciated (except for income tax purposes) on the same basis as the corresponding assets at cost.

"6. The above-mentioned appraisal report placed a value of $221,-379.83 on the pharmaceutical formulas developed and manufactured by this company. This figure was computed on the average net annual income for 1953-54-55 by valuing the 'Present worth of the net annual income discounted at 6% per annum for a period of 20 years.'

"7. At the *insistence of the management that the value* of the issued stock *be* $2.50 per share, an entry was made on the books creating an asset labeled 'Unamortized Research, Labor, and Development of Formulas,' with a corresponding credit to 'Contributed Surplus — Credit Arising from Appraisal Value of Intangible Assets.' These amounts were $202,500.

"8. In support of the value of $2.50 per share, the Texas Securities Commission in May, 1956, granted permission for the company to sell 100,000 shares of stock at $2.50 per share.

"9. Amortization of this intangible is being accomplished in 10 years rather than 20 years.

"10. At fiscal year's-end on June 30, 1958, we separated the 'Accumulated Earnings' account to show:

Deficit from Operations without Appraisal Amortization	$(14,083.06)
Deficit from Appraisal Amortization — Note 5	(83,110.82)
	$(97,193.88)

"11. At the present time, we are debating whether or not, for future balance-sheet presentation, the 'Deficit from Appraisal Amortization' account should include only the intangible asset writeoff. (Or, should this be shown separately at all?) Conversely, the depreciation for the tangible asset appraisal increase would be included in the regular 'Earned Surplus' classification.

"12. Part of this problem includes a question as to what would be 'Unrestricted Surplus' available for dividends. The *Texas Business Corporation Act* passed in 1955, under Article 2.38 A(1) Dividends, provides that

> Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation, except as otherwise provided in this act.

The *Act* also provides the following definition, viz.:

> Earned Surplus means that portion of the surplus of a corporation remaining after deducting from its net profits, income and realized gains and losses from date of incorporation or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital, or otherwise, all subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus.

"We have asked the legal counsel of the company for an opinion as to what would be 'Unrestricted Surplus,' and specifically whether or not the amortization writeoff of both tangibles and intangibles would have to be considered in determining whether a surplus was available for dividends. He has reported that he does not know the answer."

Our Opinion

At the outset we should mention that we have some serious reservations regarding the propriety of recording the appraisal values.

Personally, we find it difficult to countenance a writeup of asset values in the face of an accumulated deficit — this seems to be a contradiction in terms. An upward restatement would be warranted, *if at all,* only when the higher values can be clearly and objectively demonstrated, as for example, by reasonably expected earning power based on historical earnings and taking into account additional charges which would arise as a reflection of higher asset values. Appraisals not supported by reasonable expectation of earnings are not regarded as creditable evidence.

Regarding the value imputed to the intangibles, it appears the net annual income for the years 1953-54 and 55 represented proprietorship income computed without deduction of a salary allowance for the proprietor. Also, it appears that the present worth of average "net annual income" (which we assume refers to the *entire* average net income) was used in computing the value of the pharmaceutical formulas rather than the so-called differential earnings, if any, which measure superior earning power. In this connection, note the relevant discussion at pp. 19.3-5 and 19.41 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956). Note especially the statement (p. 19.41) that "The differential or excess earnings, the present value of which expresses the price the buyer can afford to pay for the intangibles, are calculated by deducting from the estimated periodic total earnings the total normal earnings." Note also the statement (p. 19.3) that "It is generally agreed that, unless such superior earning power can be demonstrated, there are no intangible values present." Your letter states that in evaluating the intangibles, the present worth of *20 years'* average net annual income was obtained. The *Handbook* (*op. cit. supra*), in discussing the duration and capitalization of differential earnings (at p. 19.41), states:

> ... It is generally agreed that it is unsafe to assume that such excess earnings can be realized for any very long period.... The courts in general do not approve of valuations in excess of five to six years' purchase, although in the well-known Tiffany & Co. case a multiplier of 10 was approved.

Personally, we do not believe it is proper to record intangibles in the accounts at other than a nominal valuation unless the assigned value represents cost incurred in an arms-length, i.e., *bargained* purchase thereof. We would go so far as to say that whenever a sole proprietorship or partnership is to be incorporated or a successor corporation is organized to supersede a predecessor corporation, and the same beneficial interests are in control both before and after the fact, upon transfer of properties in exchange for the stock of the newly-organized corporation, no intangible assets should be recognized on the new entity's books, unless such intangibles had previously been, or should have been, recorded on the predecessor entity's books in accordance with generally accepted accounting principles, i.e., unless cost had been incurred in a bargained purchase of goodwill or other intangible elements, or actual research and developmental expenditures had been made by such predecessor which would clearly benefit future operations. In this connection, note the statement by Hatfield at p. 19.4 of the *Handbook* (*op. cit. supra*) that "goodwill, because of its vague nature and the difficulty of verifying its appraisal, is to be excluded unless it has been purchased."

The following passage from the *Handbook* at p. 16.4 is also relevant, viz.:

> If the property is acquired as a result of the issuance of stock in connection with a combination that is a pooling of the interests, the AIA (Accounting Research Bull. No. 43) recommends that "the carrying amounts of the assets of the constituent companies . . . should be carried forward." A pooling of interests exists when "all or substantially all of the equity interests in predecessor corporations continue, as such, in a surviving corporation." The incorporation of a sole proprietorship or a partnership would be a similar situation in which "the necessity for a new basis of accountability does not arise" and hence the book value of the assets should be carried forward. If the provisions of the 1954 Internal Revenue Code are complied with, the cost to the predecessor organization will be the basis to the successor corporation; the pronouncement of the AIA Committee on Accounting Procedure, brings accounting and tax accounting together on this point.

We believe the designation "Unamortized Research, Labor, and Development of Formulas" is a misnomer and also misleading because it suggests that the amount measures or represents expenditures made either by the corporation or the predecessor proprietorship. In the absence of an express indication that the intangible is carried in the balance sheet at an appraisal value, the presumption is that the item is carried at "cost."

Regarding the question of amortization of secret formulas and processes, the following paragraph from p. 19.20 of the *Handbook* is of interest, viz.:

> Costs which can be identified with the formulas and processes are properly included in the initial valuation. Since formulas and secret processes have unlimited lives in a legal sense, it is generally held that these intangibles are not subject to amortization. If useful life can be determined with reasonable accuracy, an amortization procedure may be adopted. Otherwise, a lump-sum write-off is required when value becomes impaired.

Another point regarding amortization:

> Since intangibles represent the capitalized value of superior earning power, they are realizable for the most part only as this superior earning power produces a return.

This statement appearing at p. 19.3 of the *Handbook* suggests to us that if a 20 years' purchase basis is used in capitalizing differential earnings, a 20-year amortization period would seem to be appropriate from the standpoint of properly matching the cost against the differential income as earned.

According to our understanding or concept of the proper role or function of the balance sheet, it should not be used to reflect some pro forma projection of anticipated super-profits; rather, it is primarily a vehicle for carrying forward or deferring incurred costs and expenditures expected to benefit future operations and for reflecting liquid monetary assets and claims which *have been advanced* to, or which *have accrued* to, the accounting entity, after proper provision for all known or foreseeable losses, and reflection of all accrued liabilities and encumbrances. On principle, we would be inclined to adhere to cost except for special-purpose reporting situations. As we view it, if fixed or intangible assets do in fact have some remarkable or special service capacity or potential, this will (or should) translate itself into differential or super-profits in the usual course of business operations. Accretions to assets will be realized when and if such profits are realized.

In our opinion, the balance-sheet presentation of the Surplus or Deficit account should not separately reflect "Deficit from Operations without Appraisal Amortization" and "Deficit from Appraisal Amortization." The company must live with its representations as to higher values, and no attempt should be made to distinguish between the cumulative amortization of appraisal amounts and the cumulative excess of all other costs over revenues. The company's present (deficit) position illustrates what is envisioned or contemplated by the language used in the first paragraph of this reply, namely, "earning power based on historical earnings and *taking into account additional charges which would arise as a reflection of higher asset values.*"

On the question of proper interpretation of the term "unrestricted earned surplus" as used in the *Texas Business Corporation Act* passed in 1955, it appears that Article 2.38 A(1) of the *Texas Act* and the definition of Earned Surplus as quoted in your letter are identical with the provisions of section 40(a) and section 2(1) of the *Model Business Corporation Act* (revised, 1953, published by American Law Institute collaborating with the American Bar Association). Sections 40 and 2 of the *Model Act* deal with "Dividends" and "Definitions," respectively. For an authoritative interpretation, see the article "Earned Surplus – Its Meaning and Use in the Model Business Corporation Act," by George C. Seward (in 38 *Virginia Law Review*, pp. 435-49, May 1952). Mr. Seward was chairman of the ABA's Committee on Corporate Laws which prepared the *Model Act*. At the end of this article, Mr. Seward mentions that "Texas is presently at work on the revision of its corporate laws and in current drafts has followed the accounting definitions and related provisions of the Model Act." At pp. 440-3 of the article, the view is developed that under the *Model Act* "unrealized appreciation in asset values is available as earned surplus, and is not subject to the restrictions applying to capital surplus." Some (including ourself) may find it difficult to comprehend how it is possible to distribute something "unrealized," i.e., something not reduced to practical possession in terms of relatively liquid assets. There is also the difficulty that some accountants are not agreed on the question whether revaluation surplus may be transferred to earned surplus or whether such surplus should be "frozen." Of course, even granting Mr. Seward's interpretation, unrealized appreciation would form part of the unrestricted earned surplus dividend base only when the unrealized appreciation was "properly recognized and determined" in the first instance. This becomes a more basic question than whether the amortization writeoff of both tangible and intangible unrealized appreciation must be considered in determining surplus available for dividends. Assuming that the unrealized appreciation *is* supportable, i.e., is "properly recognized and determined," we believe that unquestionably chapter 9B, par. 2, of *Accounting Research Bulletin No. 43* (AICPA, 1953), which deals with "Depreciation on Appreciation" should be followed, viz., "When appreciation has been entered on the books (for fixed assets) income should be charged with depreciation computed on the written-up amounts." The passage dealing with amortization quoted above from the *Handbook* and chapter 5 of *A.R.B. No. 43* dealing with "Intangible Assets" would be relevant on the question whether the intangibles need be amortized at all or should be immediately written off on the ground that there is evidence that they have become worthless.

Inquiry **380**

Eliminating deficit or discount arising upon payment of stock dividend against surplus arising upon repurchase and retirement of shares

"Presented below are certain facts relative to stock transactions which occurred with a client of ours, and we would appreciate your thinking as to the financial statement presentation.

"On February 1, 1956, there was outstanding stock of 12,175 shares, par value $10. Subsequently a 150 per cent stock dividend of 18,262½ shares was declared, an additional 13,710 shares were sold for cash, and 54,000 shares were exchanged for stock of subsidiary companies. The outstanding stock was then as follows:

	Shares	*Amount (par value)*
Originally outstanding	12,175	$121,750
Stock dividend	18,262½	182,625
Sale of stock	13,710	137,100
Stock exchanged for stock of subsidiaries	54,000	540,000
Total	98,147½	$981,475

"The stock dividend, if treated as a reduction in retained earnings, creates a deficit of approximately $98,000 in the retained earnings account. In other words, at the time of the $182,625 stock dividend, the company had retained earnings of $84,625.

"In 1958, 65,480 shares of stock were repurchased by the corporation for $483,758 and retired. This repurchase created a difference of $171,042 which is represented by the excess of par value ($654,800) over the repurchase price of $483,758. Included in the repurchase was 12,750 shares of the stock dividend.

"The capital section of the balance sheet at January 31, 1959 might read something like this:

Capital stock ($981,475 less $654,800)	$326,675
Deficit	(138,000)
Excess of par value over cost of reacquired stock	171,042

"Such a presentation is awkward and rather difficult for the layman to understand.

"The corporation is now owned substantially by one family.

"What might your recommendations be for the capital section of the financial statement at the end of their current fiscal year, January 31, 1959?"

Our Opinion

If the statute in the state of incorporation requires that issued shares must be fully paid to the extent of their par or stated value, then it appears that the "deficit" of $98,000 arising out of the stock dividend is properly to be deemed "stock discount" and, ordinarily, should be described and reflected in the balance sheet as such.

The laws of many states, we understand, provide that treasury stock may be purchased only when the purchase does not impair legal capital. However, it seems to us the repurchase and retirement of its shares by the corporation in the case in question had the effect of *eliminating* the capital impairment which resulted from the previous declaration and payment of a stock dividend. Accordingly, we believe it would be proper to eliminate the portion of the deficit representing stock discount ($98,000) against the "Excess of par value over cost of reacquired stock." The balance of the deficit ($40,000) might then be characterized as "Operating deficit" (if such is the case) in the balance sheet; and the balance of the "Excess of par value over cost of reacquired stock" ($73,042) might simply be characterized as "Paid-in surplus" in the balance sheet.

Regarding the elimination or offsetting of the stock discount against paid-in surplus, note the following from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 424):

> Discount on Capital Stock. – Discount on capital stock other than preference shares generally should be deducted from the capital stock to which it relates; it may be deducted from the total of capital stock and surplus. If part of a class of stock is sold at a discount and the balance at a premium, discount and premium may be offset.
>
> When the discount applies to preference shares, it is good practice to show it as a deduction from paid-in surplus arising from other sales of the same issue (or from issues no longer outstanding) or from earned surplus. There is no logical basis for writing off the discount periodically by charges to income.

Although *Montgomery* speaks of offsetting discount and premium arising upon *sales* of the same class of shares, we do not readily see why the same offsetting treatment would not apply in a case where the discount arose out of a *stock dividend* and the "premium" or credit excess out of a *repurchase and retirement* of the same class of shares.

Incidentally, you might want to give some consideration to the propriety and feasibility of an accounting quasi-reorganization, i.e., a "fresh start" involving elimination of the entire deficit with a *dated* earned surplus account thereafter, in the circumstances of this case.[1]

[1] *Montgomery's Auditing* (*op. cit. supra*) contains a good discussion of "Quasi-reorganizations" under that heading at pp. 396-8; and chapter 7A of *Accounting Research Bulletin No. 43* (AICPA, 1953) deals with "Quasi-Reorganization or Corporate Readjustment."

Capital Stock Transactions

ISSUANCE OF STOCK

Inquiry 381

Transfer of assets and liabilities of sole proprietorship to newly-organized corporation, where proprietorship has capital deficit

"The following problem has arisen in the course of my practice, and I should appreciate your advice thereon:

"A newly-acquired client had been operating as a single proprietor in the construction business and, after many years of operation, had a deficit capital (the losses and drawings exceeded his profits) of approximately $50,000. He then incorporated and included in the corporation all of the assets which he transferred from his sole proprietorship. The net result, of course, was a deficit as of the inception of the corporation. He did put into the corporation in cash the sum of $1,000 which is the minimum starting capitalization required in this state.

"Is it correct to set forth in his balance sheet the capital stock at a figure of $1,000 with a deficit of $50,000 thereby resulting in a capital deficit of $49,000 at the inception of the corporation?

"The corporation has assumed all of the liabilities and has acquired all of the assets of the prior existing proprietorship.

"I do not see any Federal income tax consequence in this situation but would appreciate your thoughts on the tax picture as well. Is it possible, for example, for payments on such prior-existing debt to be construed as dividends paid to the stockholder (who would literally have paid the debt personally from such constructive receipt)?"

Our Opinion

To reiterate, as a matter of Institute policy, we do not undertake to give opinions on the tax aspects of questions submitted. However, we believe, in the light of what follows, that serious consideration should be given to the question raised in the last paragraph of your letter.

When we discussed this matter with you, we emphasized, among other matters, the distinction between de facto and de jure organization of a corporation and raised what seems to us to be a basic question, namely, whether a legally effective transfer of assets and assumption of liabilities may be accomplished under the circumstances of the case as outlined in your letter, i.e., whether the assumption of liabilities by the corporation is void in the likely absence of a novation; and whether the transfer of assets is voidable in the event the obligations for which the proprietor presumably remains personally liable are not paid and creditors obtain judgment liens.

We pointed out the *feasibility* of (1) recording the transfer of the assets to, and assumption of liabilities by, the corporation *as if* a valid transfer and assumption were involved; (2) reclassifying the excess of liabilities over assets (at their carrying value on the proprietorship's books) as a note receivable from officer-stockholder on the corporation's books; and (3) recording the issuance of stock having a stated or par value of $1,000, for cash. Although this *accounting* procedure would achieve a nominal parity between amounts *represented to be* assets and liabilities of the corporation sought-to-be-organized, we believe a *legal* question would remain as to whether the minimum capitalization requirements of the state corporation statute have been met, i.e., whether any capital may properly be deemed "paid into" the corporation until such time as the latter collects money from the officer-stockholder in excess of the recorded amount of the note.

INQUIRY: **381**

In our conversation we explored the possibility or propriety of transferring only a portion of the liabilities to the corporation in order to avoid the necessity of setting up a note receivable for the difference between the total assets and liabilities in question. On further reflection, it now seems to us this opens up a fruitful new line of inquiry, viz.: If the legal and tax interpretation of the transaction is that the corporation may not effectively assume the liabilities in question in the absence of a novation and, *if* further, the client is personally solvent and *will remain solvent* after transferring the assets in question to the corporation being organized, then it would appear that the assets may be effectively transferred thereto and that there is no particular point in reflecting any of the liabilities on the corporation's books (bearing in mind our assumption as to possible legal and tax interpretation of an attempted assumption of liabilities).

Another question to be considered: Even if the corporation were effectively able to assume the liabilities by means of a novation (whereby creditors were willing to discharge the proprietor from his personal obligations and look solely to the corporation for eventual payment), would such discharge give rise to income taxable to the proprietor?

Perhaps the complications introduced by raising the foregoing questions may help, nevertheless, to point the way to a sound solution. For an extended discussion of the basic question you raise, see the correspondence which *directly follows.*

Inquiry **382**

Capitalizing partners' capital deficits when corporation succeeds partnership[1]

"Your opinion as to appropriate accounting treatment of the problems outlined below would be most appreciated.

"PROBLEM NO. 1: I have been engaged to prepare financial state-

[1] This correspondence originally appeared in substantially the same form in Carman G. Blough's column, at pp. 69-70 of the September, 1956 issue of *The Journal of Accountancy.*

ments for a recently-formed corporation. The initial assets and liabilities of the corporation were those of a predecessor partnership adjusted for accumulated deficits in the partnership capital accounts, which deficits were recorded on the new corporation's records as receivables from the partners. The collectibility of the receivables is questionable as to two of the three partners. The one solvent partner will be required to put money into the corporation for his share of the deficits and also for some of his partners' deficits when, as, and if needed.

"I presume there will be no capital paid into this corporation until the corporation collects money from the partners in excess of the receivables recorded. It is highly probable that all of the receivables will never be collected because the corporation may be able to manage by using funds generated in its future operations. Your recommendations as to the present treatment of the receivables and the ultimate disposition of the uncollected receivables will be appreciated.

"PROBLEM No. 2: I do not agree with the manner in which the previous accountants recorded certain transactions in the partnership accounts. When two of the five original partners withdrew from the partnership there existed a deficit in their capital accounts. These capital accounts were eliminated by credit thereto and an offsetting debit to goodwill.

"Since I do not agree that goodwill was purchased (only nominal amounts were paid the retiring partners) in this case, my entry would have been a credit to the retiring partners' capital accounts and a debit to the capital accounts of the remaining partners, thereby showing the assumption of greater liability by the remaining partners as a result of the transactions. The existence of goodwill on the partnership records at the time the partnership turned over its affairs to the successor corporation is now being challenged, because if no goodwill is recorded, there will be an increase in the amounts recorded by the corporation as receivable from the partners (described above in Problem No. 1). Inasmuch as the partnership and the corporation have consistently shown operating losses, the recognition of goodwill does not appear to be justified."

Our Opinion

Commenting first on "Problem No. 2," we believe as you do that, in the absence of a showing of other controlling facts, the proper entry upon retirement of two of the five original partners under the circumstances described is "a credit to the retiring partners' capital accounts and a debit to the capital accounts of the remaining partners as a result of the transactions." Although we are not aware of all the facts, it is possible that the remaining partners agreed to assume the retiring partners' continuing liability for partnership debts existing at date of retirement in order to secure the withdrawal of such partners, or for other reasons. Those arrangements are not unusual. Be that as it may, it seems to us about the only situation where it might be proper for the partnership to eliminate the deficits in the capital accounts and recognize or reclassify the amounts as assets, would be either a situation where it could be shown that excessive depreciation had been taken in prior years or that capital items had been charged to maintenance, or possibly a situation where it could be shown that the actual values of the assets on which the settlement with the retiring partners was based, exceeded the amounts at which they were carried in the accounts. It goes without saying that the independent accountant should scrutinize the factual basis for such unusual adjustments in all these cases in order to satisfy himself as to their essential propriety and, even then, should insist on full disclosure. It may also be well to mention in this connection that, ordinarily, goodwill is given accounting recognition only when it is purchased in arms-length dealings, and then only at its actual cost.

It is difficult for us to give a sound opinion on "Problem No. 1" without additional information. For example, it would be helpful to know the number of shares issued or to be issued, the par or stated value thereof, if any, and the nature and amount of any property conveyed or other consideration paid or intended to be paid into the corporation by its organizers. Also, when you state that "the one solvent partner will be required to put money into the corporation for his share of the deficits and also for *some* of his partners' deficits when, as, and if needed," naturally we would like to know more about the nature of this obligation or agreement. In our opinion, also, the problem is bound up with several legal questions, answers to which we believe would considerably clarify the accounting requirements.

However, based on the facts which we have, our reaction to the problem is as follows:

a. If the partnership's total capital deficits (including the portion thereof designated goodwill) were properly reclassified as a receivable from officer-stockholders on the books of the corporation sought to be organized, and even if it is assumed such receivable is 100 per cent collectible, nevertheless, if no further capital or consideration is paid in, then the corporation would not be commencing business with the minimum amount of capital which is usually required by state statute. The corporation's assets, as represented, would be equal to its assumed liabilities to third-party creditors. If any stock with a par or stated value were issued under such circumstances, stock discount to the extent of such par or stated value would have to be reflected.

b. If, as a matter of fact, such receivables are only partially collectible or are entirely uncollectible, then it appears that the corporation sought to be organized would be insolvent ab initio. Therefore, at least enough capital consideration would have to be contributed in excess of the minimum amount of capital required to commence business as a corporation to absorb the amount by which the receivable must be discounted in value or written off.

As we see it, it would be very helpful to have a competent attorney's opinion on a number of questions, including the following: (1) What is the minimum legal capital that must be paid in before a corporation can begin to do business in the state in which the corporation seeks to be chartered? (2) As a prerequisite to the winding up of a partnership and *de jure organization* of a corporation which is to take over partnership assets and assume partnership obligations, must good and sufficient consideration in the amount of the predecessor partnership's capital deficits be unconditionally *paid* to the corporation sought to be organized? (3) Would an *unconditional promise to pay* the amount of the capital deficits, given by a solvent former partner or partners to the corporation, be regarded as sufficient consideration to place the assets and liabilities of the corporation sought to be organized on a parity? (4) Would a "when, as, and if needed" understanding or promise to pay the amount of the capital deficit given to the corporation by one of the former partners achieve parity between corporate assets and liabilities to third parties?

Our own personal conclusion on this matter is as follows: What was once a capital deficit remains, or should remain except in very special extenuating circumstances, a capital deficit. To transmute a capital deficit into an asset merely by dissolving or terminating a partnership (or attempting to) and organizing a corporation (or attempting to) seems pure alchemy. We use the words "attempting to" because there appears to be a real question here whether there has been a *legal winding up* of the partnership and/or *de jure organization* of the corporation. The independent accountant's prime responsibility is to see to it that financial statements to which he lends his name clearly and fairly present the facts. Accordingly, unless the capital deficit is made up to the corporation or there is a compromise of indebtedness or arrangement with creditors, we believe any balance sheet prepared for the corporation at this stage should be presented and headed up as a "Statement of Assets, Liabilities, and Deficiency of Capital" for a corporation *in process of organization.* (See the item which appeared in Carman G. Blough's column entitled "Financial Presentation When Deficit Exceeds Capitalization," in the August, 1954 issue of *The Journal of Accountancy*, especially the suggested form of statement at p. 204, which you may be able to adapt to your purposes.)

If the client insists on showing the capital deficiency as a receivable, we believe that, as a *minimum*, you should set the receivable up separately, indicating that it is a receivable from officer-stockholders and disclosing in a footnote that the corporation's claim is based on the capital deficit of a predecessor partnership, liabilities of which the corporation has assumed. As to ultimate disposition of the uncollected receivable: It seems clear that any writeoff due to high improbability or impossibility of collection or due to the fact that the corporation has "forgiven" the debt owed to it, should be made to the earned surplus or deficit account. If the corporation has operating profits in future years and dividends are declared, the fair thing to do, it seems to us, would be to set the dividends off against the receivable until the latter is extinguished.

Inquiry **383**

Incorporation of partnership — some considerations involved in issuance of stock for partnership assets, promotional stock to former partners, and in recording underwriting agreement

"Could I have your assistance in recording certain journal entries in a new corporation which went public under Regulation A. I want to be sure that I use the most acceptable method to reflect the clearest picture.

"The corporation purchased the assets of a limited partnership in exchange for stock, and the following journal entries are in my working papers awaiting word from you whether they are proper:

(1) Equity – Partners	$ 12,578.25	
Capital stock		$ 8,333.00
Paid-in surplus		4,245.25
To record issuance of 8,333 shares of capital stock, $1.00 par value, in exchange for partnership assets		
(2) Organization expense	$ 4,853.46	
Franchise tax expense	100.00	
Accounts payable		$ 4,953.46
To record Organization expense & Franchise taxes payable to attorneys		
(3) Accounts receivable – Underwriter	$265,500.00	
Underwriting discounts & commissions	34,500.00	
Capital stock		$100,000.00
Paid-in surplus		200,000.00
To record Underwriting agreement		
(4) Goodwill (or Promotional stock issued)	$ 50,000.00	
Capital stock		$ 50,000.00
To record issuance of promotional stock to former partners."		

Our Opinion

Regarding your first journal entry, it seems to us that the various assets taken over from the partnership should be debited rather than the account "Equity – Partners."

Upon inception of a corporation, it seems to us every effort should be made to reflect fair values for the assets taken over in consideration of the issuance of stock. Both *understatement* and *overstatement* of the *value* of the initial complement of assets should be scrupulously avoided, the former so that the accounts will reflect the most meaningful and useful cost for subsequent accounting purposes, the latter so that there will be no unwarranted "puffing" or "watering" of capital.[1]

This general principle having been stated, we should hasten to add that where the newly-organized corporation is a *successor* to another business entity and a *continuance of beneficial interests* is involved, "book value" to the transferor or predecessor entity should not be lightly abandoned as a basis for recording the assets transferred to the corporation – especially if the predecessor has, in its past accounting, consistently adhered to generally accepted principles. Contrary to what you state in your inquiry, actually there has been no "purchase" of the assets of the limited partnership for stock. Assets have been transferred to the newly-organized corporation, but no assets have been severed therefrom nor debt assumed. There is a definite *continuance* of the old ownership interests (albeit additional ownership interests are about to enter the picture through public sale of stock), and a mere change in the legal form of the business entity.

With regard to costs of incorporation and costs of raising capital, see the excellent discussion in Newlove and Garner's *Advanced Accounting* (D. C. Heath & Co., Boston, 1951, vol. 1, pp. 65-9) and the discussion at pp. 314 and 384-5 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957). We would be inclined to prefer the term "organization costs" rather than "organization expense" as used in journal entry "(2)." We also believe the franchise tax expense could well be merged with the other costs of organization or incorporation, at least for statement presentation purposes.

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1 A most important caveat appears in Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962) at pp. 38 and 41, viz.: "The issuance of 'watered stock' is fraudulent in law as against existing shareholders (unless they are estopped by having voted for its issuance) and subsequent bona fide creditors. Both the purchasers of such shares and the directors who voted for their issuance may be personally liable for an unpaid subscription. The measure of that liability varies considerably under the statutes of different states. There is a widespread impression that if par value shares have been issued, the measure of liability for stock watering is only the difference between what is actually paid for the shares and their par value; and that if no-par shares have been issued, liability can be avoided completely. Neither impression is correct. . . .

"The stock watering statutes which impose liability upon subscribers to shares and upon directors who authorize their issuance, often measure that liability by the 'inflation' in the balance sheet, i.e., the amount by which the property or services have been overvalued. Accordingly, counsel must take particular care that the directors do not overvalue property or services accepted as consideration for shares *of either type*, and should advise his clients that the fact that the overvaluation appears in the surplus account, rather than in the capital stock account, affords no real protection."

In our opinion, where the underwriting agreement is in the form of a so-called "firm commitment" deal (rather than a "best efforts" deal) the transaction may fairly be deemed tantamount to a present purchase of, or a subscription to, the securities involved. Accordingly, upon signing the underwriting agreement it would be acceptable to record an account receivable from the underwriter with corresponding credits to capital stock and paid-in surplus as required. We believe, in such circumstances, the more desirable practice is to have the underwriter give a check to the corporation for the gross selling price of the securities and then to have the corporation issue its own check for the underwriter's commissions.[2] If this latter procedure were followed, the debit to the "Accounts receivable — Underwriter" account in your journal entry "(3)" would be set up at the gross selling price of the securities.

Concerning the propriety of entry "(4)," see the discussion at pp. 72-6 of Paton and Paton's *Corporation Accounts and Statements* (Macmillan Co., N.Y., 1955).[3] In addition, we believe the following comment appearing at pp. 16.8-9 of Rappaport's *SEC Accounting Practice*

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[2] In this connection, the following provision (section 507) of the *New York Business Corporation Law* which became effective September 1, 1963, is of interest, viz.: "Reasonable expenses of organization or reorganization or reasonable expenses of and compensation for the sale or underwriting of shares may be paid or allowed out of the consideration received for such shares *without impairing their fully paid status*" (*our emphasis*).

[3] See also the item entitled "Treatment of Promotional Shares Held in Escrow" in Carman G. Blough's *Practical Applications of Accounting Standards* (AICPA, N.Y., 1957) at pp. 359-61.

The following comments regarding the "Consideration for Which Shares May Be Issued" in Israels' and Gorman's *Corporate Practice* (*op. cit.* footnote 1) at pp. 38-9, are well worth noting, viz.: "The consideration must be of an acceptable type, i.e., it must meet the criterion of 'labor done, or money or property actually received.' The decisions of the state of incorporation must be carefully checked in this connection. Thus, in New York, promoters' services are not 'labor done,' and a contract to render services in the future is not 'property.' In Delaware there is the same limitation with respect to a contract to render services in the future, but promoters' services appear to be adequate consideration for the issuance of shares. The courts do not agree as to the acceptability of promissory notes as consideration for the issuance of shares, and some statutes specifically prohibit their acceptance." Query whether promoters' services are an acceptable consideration for issuance of shares in New York since enactment of the *New York Business Corporation Law*? In an article, "Provisions of New Business Corporation Law of Interest to CPAs" (*The N.Y. CPA* for September, 1963), W. W. Owens states, as follows: "As heretofore, shares may be issued for property, tangible or intangible, and for *labor or services performed for the corporation or in its formation* (Sec. 504(a)), but they may not be issued for services yet to be performed (Sec. 504(b)). The obligation of the subscriber to pay for his shares, even if evidenced by his note, does not constitute payment (Sec. 504(6))" (*our emphasis*).

and Procedure (Ronald Press Co., N.Y., 2nd edition, 1963) is worth noting:

> Where the amount of promoters' fees included in the asset organization expense is so indefensibly large as to be outside the range of reasonable difference of opinion as to the value of the services performed by the promoters, the conclusion must be that some of the stock issued to the promoter represented a donation to the promoter — not an asset of the corporation. Brandy-Wine Brewing Co., 1 SEC 123 (1935).

It is not entirely clear from your journal entry "(4)" whether *50,000* shares were, or are being, issued to the promoters. It appears that the underwriters plan to sell the securities to the public at a price of at least $3 per share. If such market price is substantiated by actual sales to the public, and 50,000 shares are being issued to the promoters, then it would seem that, logically, a value of $150,000 attributable to the promotional shares would have to be supported or justified. On the other hand, if the promotional services are assertedly worth $50,000, then it would appear that only one-third of 50,000 shares should have been, or should be, issued to the promoters.

Inquiry 384

Recording property on books of newly-organized corporation at amount exceeding recent purchase price

"As a member, may I have your opinion or the pros and cons re the following situation taking place in . . . . State?

"A, B, and C buy some land and hold it for six months. It costs them $30,000.

"A, B, C, D and E agree to form a corporation, which is to issue one share of its no-par value capital stock to each of them for:

A pays	$1,666.67	Cash & his 1/3 of land at	$13,333.33
B	1,666.67	" "	13,333.33
C	1,666.66	" "	13,333.34
D	15,000.00	Cash	
E	15,000.00	"	
Totals	$35,000.00		$40,000.00

"D and E know when A, B and C bought the land and how much they paid for it but agree to the named arrangement in belief that the land is worth at least $40,000. In fact, I am told that a banker, also knowing the facts, is of the opinion that it is worth $50,000, and is willing to arrange a mortgage to be effective when a building is completed as designed by an architect.

"As a non-taxable transfer, A, B and C understand that their respective bases of the one share of capital stock owned by each of them would be:

A	$11,666.67
B	11,666.67
C	11,666.66
	$35,000.00

"If the issuance of and payment for the capital stock was recorded on the corporate records:

Debit		
Cash	$35,000	
Land	40,000	
Credit		
Capital Stock Issued		$75,000

does there appear to be any basis for criticism? Since the land is not excessively valued, would there be any need to disclose the basis in the hands of transferors in view of the fact that it was a non-taxable transfer? If so, what ways of disclosing the basis ($30,000) are considered appropriate?"

Our Opinion

Our personal opinion is that unless there is more objective or credible evidence than the "belief" of certain interested parties that the fair value of the land has increased 33 per cent within six months, then it is improper to set up the land at $40,000. By this procedure, we believe, the corporation's balance sheet would reflect "watered capital." There is a presumption that an item is stated at "cost" unless a different carrying-value basis is indicated. Accordingly, if the land is recorded and reflected in the balance sheet at $40,000, then we believe the rule of informative disclosure requires *as a minimum* that the company indicate the carrying-value basis as being "stated at current fair value as determined by officer-stockholders." If the company fails to make this disclosure, we believe it incumbent on you to disclose the carrying-value basis in your report. We know of no express requirement that the cost of the land to predecessor, i.e., the tax basis, be indicated.[1]

Inquiry **385**

Accounting for employees' stock purchase plan where employer's contribution deemed non-compensatory

"Based on the facts as presented in the following memorandum, will you please furnish us with the accounting entries necessary to reflect the indicated transactions as they occur?

"The X Company is a publicly-held corporation listed on the New York Stock Exchange. It and its domestic subsidiaries employ in excess of 5,000 persons in the United States. In order to (a) raise additional capital and (b) encourage widespread ownership of its shares among its employees, it desires to establish a Stock Purchase Plan.

"The Plan will provide, in essence, that each employee of the parent and its subsidiaries will be entitled to purchase in each year the parent's shares of a value not in excess of 5 per cent or 6 per cent of such employee's compensation for such year. All purchases will be at market at the time of purchase.

"For each share or for each two shares (the exact amount has not yet been determined) purchased by an employee and contributed to the Stock Purchase Trust, his employer will contribute one share to the Trust, without cost to the employee. Shares contributed to the Trust by employees will vest immediately and will not be subject to forfeiture.

"Shares contributed by the employers will vest in installments of 20 per cent annually; the first portion of each contribution to vest

[1] Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962) at pp. 37-45, especially the discussion commencing with par. "(4)" at p. 40 and continuing to the top of p. 45, is quite relevant to this client's situation.

after either 18 or 24 months. The employee's interest in these shares will be subject to forfeiture for cause. Withdrawal by an employee of shares which he contributed will forfeit all of his right to shares contributed by his employer, to the extent they have not already vested.

"X Company believes that the value of the shares to be contributed by it and by its subsidiaries to the Trust will not constitute compensation to the employees for whose benefit the shares will be contributed, on account of the substantial restrictions attached to those shares, as well as to the shares contributed by the employee. The proposed restrictions include the following: (1) all shares will be voted and held by trustees named by X Company; (2) the trustees will not be permitted to sell any shares of X Company stock, even in anticipation of substantial market downturn; (3) shares contributed by the employers will not vest fully except after passage of either 5½ or 6 years; (4) except upon death or termination of employment, a participant in the Plan may not receive and, therefore, may not sell or otherwise dispose of shares held in the Trust as a result of employer's contributions; and (5) withdrawal from the Trust by an employee of shares contributed by him will automatically forfeit his interest in the non-vested portion of shares contributed by his employer for his benefit.

"X Company believes that the policy and attitude of the American Institute of Certified Public Accountants, as set forth in par's 4, 5 and 12 of chapter 13B of *Accounting Research and Terminology Bulletins* (AICPA, 1961) precludes treating as compensation the market value of shares contributed by the employers."

Our Opinion

In our opinion, the Stock Purchase Plan described in your memorandum, from a realistic standpoint, involves the issuance of two shares for the price of one, subject to certain restrictive conditions which defer vesting of full title to the matching share but which, nevertheless, lapse in the course of time (five and one-half to six years). Stated more precisely, if certain conditions precedent are met in whole or in part in the ordinary course of his employment, an employee may acquire a vested future interest in a minimum of 1.2 and maximum of 2 parent company shares for the price of 1 share (as measured by the prevailing market price at the date he elects to purchase).

Another conclusion which we would draw is that the Stock Purchase Plan or Trust described in your submitted memorandum involves *deferred* compensation or gain, and fundamentally does not differ from a self-administered pension plan which is contributory on the part of the employee. A *portion* of the deferred compensation or gain ultimately to be received by an employee purchasing a share of stock and transferring it to the custody of the trust is *contingent* – contingent on the passage of time as well as the point in time when the employee draws out the share or shares (with accrued dividends?) which have vested in his favor.

The statement in your memorandum that for each share purchased and contributed by an employee "his employer will contribute one share to the Trust, without cost to the employee," is, in our opinion, questionable. A corporation's shares (except stock dividend shares) *must* be issued for an acceptable type of consideration, generally money, property, or labor or services actually rendered. It appears that shares issued literally "without cost" or consideration would be void, voidable, or assessable. This is not to say, however, that it is difficult to find a consideration for the shares transferred to the Trust by the employer, viz., consideration may be found *either* in the services actually rendered by the employee during the 5½ or 6-year period prior to the vesting of his rights to the matching share *or* in the money consideration actually paid by the employee (based on current market value of one share).

Our essential view, then, is that the compensation or gain here is contingent on, and a function of, the employee's serving time – perhaps it would be better to use the more euphemistic "employee's service time."

This is not to say that someone may not make out or rationalize a case for present "compensation" here based on the language of par. 4 at p. 120 of *Accounting Research and Terminology Bulletins* (AICPA, 1961), viz.: on the ground that compensation must be presumed here since the inducements are "larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital."

Be that as it may, even if one were to go so far as to hold that the stock-purchasing employee, insofar as he has availed himself of a "bargain purchase," has an immediate compensation or economic gain, *we do not believe the corporation should record "compensation" at any time under this Plan.* In our opinion, to do so would introduce a hypothetical consideration into the corporation's accounts. We personally would cleave to the view that a corporation should never record compensation in its accounts unless a transaction is involved which results in a reduction of an asset or the creation of a liability resulting in an ordinary debtor-creditor relationship. At no time would the Plan in question require same. At no time would this Plan involve a "distribution, division, or severance of corporation assets" (except for any cash dividends) accruing in favor of the stock-purchasing employee. In point of fact, any gain arising from enhanced market value of the corporation's shares and currently or ultimately redounding to the employee, is initially accomplished by removal or waiver of the pre-emptive rights of other stockholders and *consequent dilution of such stockholders' equities upon assigning matching shares to stock-purchasing employees.*

In any event, the main effect of recording compensation in the amount of the market value of a matching share "contributed" to the Trust by the employer, would be to reduce current net income by that amount, indirectly capitalizing earned surplus and transferring such amount to capital or paid-in surplus. By issuing shares as an inducement to greater future employee effort, and charging compensation to the income account and correspondingly crediting paid-in capital in an amount measured by the current market value of the shares, in our opinion, the corporation understates its "true" net income and inflates its contributed capital.

Accordingly, in accounting for issuances of shares under this Plan, we personally from a going-concern standpoint would be inclined to deem the matching share as being "issued"[1] at the same time that the other share is issued to the employee and transferred to the Trust, *and for the same consideration.* Thus, if the market price per share were $100 and 2 shares with a par or stated value of $10 per share were transferred (one by employee, one by employer), the credits to capital stock and to paid-in capital would, of course, be $20 and $80, respectively. A mechanical difficulty would arise in any case where the consideration paid into the corporation (i.e., market value of one share) did not equal or exceed the par or stated value assignable to two shares. Another approach (which we do not personally favor) would be to reflect only one share as being issued at the time the employee purchases same and transfers it to the Trust. Then, portions of the

[1] In the customary escrow or stakeholder situation, it appears that the share "contributed" by the employer would not technically be *issued* until all conditions precedent to the vesting of the share in the employee had been met.

capital surplus arising from the issuance of such share (equivalent to 20 per cent of the par or stated value of a share), could be periodically transferred to what would essentially be a "capital-in-process" account as 20 per cent interests in the matching share, vest. How such an in-process capital account should be designated is problematical. A possibility would be "Vested equities in stated capital – employee stock purchase plan." When and as full shares become vested, the par or stated value thereof would then be transferred to the capital stock account.[2]

Inquiry **386**

I. Exchange of par value for no-par stock — where historical amount of consideration paid in, is less than par value of issued shares
II. Dividend payment based on time preferred shares of record were outstanding during fiscal period

"One of our clients has presented us with two accounting problems. The larger problem has to do with the exchange of par value stock for no-par stock. The other has to do with accumulated dividends on preferred stock. I shall describe the problem below and the action that we took and propose to take.

I. Exchange of Stock

"In the course of reviewing the minutes and capital stock records of our client as part of a fiscal year-end audit, we learned that the stockholders had voted and the State Secretary had authorized them 'to increase the authorized capital stock from 200 shares of no-par to 40,000 shares of $5.00 par' and 'to issue 100 shares of $5 par in exchange for each share of the no-par capital stock previously issued

[2] For some relevant background material, see the article "Compensation Through Corporate Stock" which appeared in Winter, 1960 issue of *University of Cincinnati Law Review*, esp. at pp. 57-65. See also *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 390-2; and at pp. 1354-5 of *Accountant's Encyclopedia* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1962, vol. IV).

and outstanding.' The transaction was consummated after the balance-sheet date.

"The problem arises from the fact that the par value of the new stock exceeds the stated value of the old stock. There were 200 shares of the old stock authorized, issued and outstanding. The stated value was $11,884.24. These shares were exchanged for 20,000 shares with a par value of $100,000.

"In our report we commented on these facts as follows:

> Shortly after the balance-sheet date, during the period from April 13th to May 10th, the no-par common stock was exchanged for $5 par value common stock and retired. The basis for exchange was 100 shares of the new stock for each share of the old, resulting in the issuance of 20,000 shares of common $5 par stock having a total par value of $100,000.
>
> We have been assured by Company counsel that the issuance of common stock with a total par value of $100,000 in exchange for no-par common stock with a stated value of $11,884.24 raises no legal problems in the state of X. The exchange was sanctioned by the Secretary of State of X.

"Next year we shall have to reflect the facts on the balance sheet, and we have in mind the following presentation under the general heading of capital stock (our client hopes that we will be able to avoid the word 'discount'):

Common, $5 par, authorized 40,000 shares	
Issued and Outstanding 20,000 shares	$100,000.00
Less: Excess of Par Value over Net Assets Paid in on Common	88,115.76
Stated Value	$11,884.24

"The company started in business with net assets of $20,059.24 and capital stock as follows: $25 par 9 per cent cumulative preferred of $8,175 and no-par common of $11,884.24. The individuals who owned the 200 shares of no-par now own the 20,000 shares of $5 par. Assuming that 10,000 additional shares are sold during the current fiscal year, should the discount applicable to the first 20,000 shares be specifically identified?

For example:	
Issued and Outstanding, 30,000 shares	$150,000.00
Less: Excess of Par Value over Net Assets Paid in on the First 20,000 shares	88,115.76
Stated Value	$ 61,884.24

"*Accounting Trends and Techniques,* 13th edition, on page 116 shows how Abbott Laboratories presents a difference between par and stated value of their common stock. Should not the amount of premium on their capital stock have been segregated and designated as a type of paid-in surplus? Would you be in favor of our abbreviating our presentation so as to parallel Abbott's presentation?

II. Accumulated Dividend

"Our client is authorized to issue 2,500 shares of $25 par value cumulative preferred stock. The certificates state that dividends will be paid *at the rate of 9 per cent per annum* (*emphasis supplied*).

"This wording was adopted because it was the intention of the management of the company, from the very beginning, to pay the dividends as interest is paid on debentures and bonds. They did not know that dividends on stock are usually or customarily paid at the stated rate times the par value of the shares outstanding as of the date of record. During the fiscal year under review dividends were paid on all amounts 'accrued' as of the end of the previous fiscal year. The Treasurer had computed the dividends 'accrued' during the year and reflected the amount in accounts titled 'Dividends Paid' and 'Accrued Dividends.' Subsequent to the balance-sheet date the directors voted to authorize the Treasurer to pay a 9 per cent dividend 'to all stockholders of record for the fiscal year ending March 31, 1960. Total amount to be paid $1,338.96.' In the balance sheet we described the accrual as 'Accumulated Dividends on Preferred Stock,' and in our comments on balance-sheet items, we said:

> This account represents the accumulation of dividends from April 1, 1959, all prior dividends having been paid prior to the balance-sheet date. Dividends were accumulated on all shares outstanding at March 31, *computed at the rate of 9% for the period that the shares were outstanding during the year.*
>
> Total dividends charged against Retained Earnings amounted to $1,341.96, which includes $3 paid on 10 shares cancelled during the year.

"We asked Company's counsel if there might be any contingent liability for dividends paid at less than the full amount of 9 per cent of the par value of the shares outstanding as of date of record for the current year and for prior years. We were advised that the wording in the stock certificate 'at the rate of' should prevent any action to recover what a stockholder might claim was the unpaid portion of such dividends."

Our Opinion

I. Regarding your questions on the exchange of stock: As you probably know, for par value shares, almost all statutes require a minimum sale price or consideration equal at least to the par value of the shares. Accordingly, assuming $88,116 of surplus is not available for capitalization upon issuance of the 20,000 shares of $5 par value stock, we believe the rule of informative disclosure would better be served by designating the $88,116 as stock discount. We feel that your suggested designation is less informative than, say, "Less: Stock Discount (Excess of Par Value over Net Assets Paid in on Common)." Assuming 10,000 additional shares are sold, we do not believe it would be required, and we would not be inclined to identify the discount as being specifically applicable to the first 20,000 shares issued.

We also feel it is undesirable, if not improper or confusing, to use the term "Stated Value" in the particular context. The terms "Stated Value" and "Stated Capital" are legal terms of art having reference to the per share and total amounts, respectively, represented or deemed to be the "Legal Capital," i.e., the capital buffer of a corporation. While the no-par shares were outstanding, it was proper to refer to the $11,884 amount as their "Stated Value" or as the "Stated Common Capital." However, we believe this term in its technical meaning is no longer applicable now that the no-par shares are no longer outstanding. The figure designated as "Stated Value" would more accurately be described as "Amount Paid in on Common Stock."

Incidentally, the Abbott Laboratories presentation is to be distinguished from the case in question: the Abbott presentation does not involve *stock discount,* and presumably is a situation where the board, by proper resolution or otherwise, has determined that it will represent its legal or "Stated Capital" to be an amount greater than the total par value of outstanding shares. Accordingly, in our opinion, it would be improper to abbreviate your presentation to parallel that of Abbott.

The exchange transaction described in your letter is rather odd or unorthodox, to say the least. With all due deference, it may well be that the legal effects of the issuance in question could stand some rechecking or further clarification either by the client's counsel or the State Secretary unless, in the particular state jurisdiction, the term "par value" has lost *all* meaning or significance. According to our understanding, some states allow the original issuance of par value shares for a consideration less than the indicated par value without such issuance being deemed void ab initio, so long as a minimum capitalization standard is met and the board feels that the shares cannot otherwise be sold for the full par amount. Whether shares issued under such circumstances are nevertheless assessable in certain contingencies is not always made explicit. In other jurisdictions issuance of shares for a consideration less than their par value may be "tolerated" in the sense that issuance under such circumstances does not *void* the shares. However, the shares may be made *voidable,* or subject to *possible future assessment* for not being "fully-paid."

II. Regarding the accumulated dividend situation described in your letter, we believe you would be justified on the basis of the considered opinion of the company's counsel to omit reference in the financial statements to any contingent liability. The practice of computing dividends at the rate of 9 per cent for the period that specific shares were outstanding during the year would seem to be supported by the not infrequently encountered practice of surcharging an investor for accrued dividends on preferred stock when he buys in at an interim date (see "Purchased Dividend Accruals," item in Carman G. Blough's column, June 1947 issue of *The Journal of Accountancy*); also, by the practice of open-end investment companies whereby the investor is charged with a so-called "equalization" amount representing the income which would have been earned on the sum otherwise invested if such sum had been invested at the beginning of the fiscal period rather than at an interim date.

Inquiry **387**

Issuance of par value shares for consideration substantially less than par value

"A question has come up concerning the correct accounting procedures for a corporate reorganization. Following are the facts as they happened (I shall call the corporation Company X).

"1. Company X incorporated in 1940 under the laws of Indiana with 1,000 shares of no-par common stock. As of April 1, 1959, there were 600 shares issued and outstanding with a stated value of $1,500. Three stockholders each held 200 shares. Retained earnings amounted to $9,000.

"2. On April 2, 1959, Company X amended its Articles of Incorporation to read as follows: —'authorized capital consists of 400,000 shares of $1 par value common stock.'

"3. On the same day the three stockholders issued to themselves 75,000 shares of $1 par stock in exchange for their original holdings of 600 shares of no-par stock. This transaction was approved by the SEC. The reason for the additional authorized stock is the proposed public sale to finance the purchase of a going concern.

"Should this transaction be stated as follows in the net worth section?

Capital stock issued and outstanding (75,000 shares @ $1 par)	$75,000
Less: Excess of par value over paid-in capital	(73,500)
Retained earnings	9,000
Total shareholders' investment	$10,500

"Capital stock has to be shown as $75,000 to reflect the 75,000 shares issued at $1 par. The $73,500 figure ($75,000 less $1,500 previously stated value of no-par stock exchanged for 75,000 shares) in my opinion, has to be shown as above."

Our Opinion

According to volume 2 of Prentice-Hall, Inc.'s *Corporation Report* service, section 25-205(c) of the *Indiana General Corporation Act* provides, in part, as follows:

> Consideration for Shares. Shares of stock having a par value may be issued for an amount of consideration not less than the par value thereof, unless the articles of incorporation provide that such shares may be sold at less than their par value, in which case such shares may be issued for such consideration as may be fixed from time to time by the board of directors in accordance with such provision.

In the light of the foregoing, we believe the presentation of the net worth section as set forth in your letter (with slight, but we think important, modification of language), would be *required, unless* the articles of incorporation provide that par value shares may be sold or issued at less than their par value and the board of directors has fixed the consideration therefor. If the articles do not so provide, then, in our opinion, the manner of presentation which you recommend should be used, except that we feel the ($73,500) item should be described as "Less: Stock Discount" or "Less: Stock Discount (measured by excess of par over paid-in value of outstanding shares)."

If, on the other hand, the articles provide that par value shares may be sold or issued at less than their par value and the board has in fact fixed the $1500 of previously paid-in capital as the amount deemed to be the consideration for the newly-issued par value shares, then we believe the net worth section may properly be presented as follows:

Capital stock issued and outstanding (75,000 shares @ $1 par)	$1,500
Retained earnings	9,000
Total shareholders' investment	$10,500

This presentation properly portrays the facts as to the amount of past consideration actually paid into the corporation and number of new shares outstanding prior to the proposed public sale. Incidentally, it seems to us that whenever a substantial number of par value shares are *lawfully* issued for a consideration less than par, a factual statement of the board's action in this respect might well be made in a footnote to the balance sheet to dispel any presumption by a reader of the statement that the holders of outstanding stock are subject to further assessment or that the issued stock is voidable. We are constrained to observe further that a statutory provision such as that cited seems to deprive the classical concept of "par value" of all meaning and content.

Inquiry **388**

Subsidiary's issuance of stock to parent for property with fair value less than par value of stock

"We would appreciate receiving from you advice as to the proper accounting procedures to be used in the following situation:

"Corporation A owns 95 per cent of Corporation B. Corporation A is to transfer property with a book value of $200,000 to Corporation B, in exchange for stock of Corporation B with a par value of $400,000. It is not proposed to prepare consolidated financial statements for these two companies.

QUERY

"What nomenclature should be given to the $200,000 debit account resulting from the difference of par value stock issued and the basis of assets received for such stock (assuming that the $200,000 represents fair market value)?

"What would be the proper procedure for writing off this account in the future?"

Our Opinion

In our opinion, the difference between the $400,000 par value of stock issued by Corporation B and the $200,000 assumed fair market value of property received from Corporation A in exchange therefor represents stock discount, and should be reflected in the balance sheet as "Discount on Capital Stock Issued." The stock has been issued for a consideration less than the aggregate par value, and accordingly, in many if not most states, such stock would be deemed not legally fully paid. Assuming that the carrying value of the property transferred by Corporation A does in fact represent current fair value, then we believe that if Corporation B were to reflect the $200,000 differential as part of the carrying value of any of its assets, such presentation would be tantamount to watering such corporation's capital.[1]

We believe the following passage from *Montgomery* (*op. cit.* footnote, p. 424) is relevant:

> Discount on capital stock other than preference shares generally should be deducted from the capital stock to which it relates; it may be deducted from the total of capital stock and surplus. If part of a class of stock is sold at a discount and the balance at a premium, discount and premium may be offset.

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[1] See *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at top of p. 384.

> When the discount applies to preference shares, it is good practice to show it as a deduction from paid-in surplus arising from other sales of the same issue (or from issues no longer outstanding) or from earned surplus. *There is no logical basis for writing off the discount periodically by charges to income* (*our emphasis*).

As for *future* writeoff of the discount (assuming no actual assessment of the parent-company stockholder), one possibility to explore would be a recapitalization formally reducing the stated capital of the subsidiary thereby creating a "reduction surplus" sufficient to absorb a writeoff of the discount. Ordinarily, a recapitalization requires stockholder approval, amendment of the articles of incorporation, and filing with the Secretary of State or Commissioner of Corporations for certification.[2]

Inquiry **389**

Issuance of stock for patent by recently-organized corporation — on what basis should stock and patent be recorded?

"We shall appreciate having your opinion on a matter involving determination of cost of patent acquired by periodic issues of capital stock.

"An individual owning a patent entered into an agreement transferring the patent to a corporation. The consideration for the transfer was entirely capital stock of the corporation, part of which was issued at the time of organization of the corporation, and the remainder to be issued to the individual from previously unissued shares, over a period of time.

"At the end of the first and each succeeding fiscal year of the corporation, one share of the corporation's capital stock was to be issued for each one-half of 1 per cent by which the net earnings of the corporation exceeded 10 per cent of the total par value of the corporation's issued and outstanding stock at the end of the fiscal

[2] For a discussion of accounting and other relevant aspects of stock discount, see Paton and Paton's *Corporation Accounts and Statements* (Macmillan Co., N.Y., 1955) at pp. 55-9 and 65-8.

year. Such issuances would continue on that basis until the seller had acquired an aggregate of 44 per cent of the corporation's issued and outstanding stock (such outstanding stock including, of course, shares issued to the seller).

"A seven-year limitation provided by the agreement proved to be inapplicable: the issuance of 44 per cent of the total stock to the seller of the patent was in fact completed after the fourth year of corporate operations.

"The problem involves the basis of recording the cost of the patent, contra to capital stock equity, with respect to the issuances of shares other than those issued at the time of organization.

"The company believes that the par value of the issued shares is the appropriate basis, notwithstanding the facts that (1) the par value is only nominal, (2) the patent constitutes the corporation's most important business asset, and (3) earnings have greatly exceeded the 10 per cent specified in the agreement.

"There is no objective basis for valuing the patent, and accordingly, we believe that the recording of the periodic issuances should, in some appropriate manner, be based upon the fair value of the stock. There is no quoted market, and essentially no 'market' in any useful sense: the corporation's shares have been sold, but only sporadically, in small lots, at widely divergent prices, sometimes with some difficulty.

"It appears to us that ascribing to the issuances of stock a value based upon capitalization of earnings for the applicable fiscal year might be an appropriate procedure; we believe that such a basis would be more useful than one looking to book value. While we recognize that determination of capitalization rate or rates is necessarily somewhat subjective, we would be inclined to regard a rate of 10 per cent as being both (1) reasonably conservative in the light of the company's limited earnings history, and (2) not inconsistent with the terms of the patent acquisition agreement which, you will remember, appears to contemplate that rate as constituting a norm for operations.

"We shall appreciate your comments as to an appropriate accounting procedure in the circumstances as outlined above, including any precedents or examples which you may know of."

Our Opinion

Accounting Research and Terminology Bulletins (AICPA, 1961) chapter 5, "Intangible Assets," par. 4, p. 38, states the following:

> The initial amount assigned to all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, as, for example, where intangibles are acquired in exchange for securities, cost may be considered as being either the fair value of the consideration given or the fair value of the property or right acquired, whichever is the more clearly evident.

We submit that, in the specific set of circumstances outlined in your letter, it is impracticable if not impossible to apply the foregoing rule relating to non-cash transactions. As you state in your letter: "There is no objective basis for valuing the patent, and accordingly, we believe that the recording of the periodic issuances should, in some appropriate manner, be based upon the fair value of the stock. There is no quoted market, and essentially no 'market' in any useful sense: the corporation's shares have been sold, but only sporadically, in small lots, at widely divergent prices, sometimes with some difficulty."

Furthermore, we believe use of the par or stated "value" of the shares issued would only coincidentally, if at all, measure the "value" or "cost" of the patents.[1] As *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 245) states:

> When stock alone is issued, the par or stated value of the stock usually cannot be relied upon as a reasonable basis for recording the cost of the property acquired. If the fair value of stock is not readily determinable, some appraisal of the property must be made, either by the management or by outside parties, taking into consideration all pertinent factors.

In our opinion, this latter appraisal approach also appears to be a "dead end," in view of the speculative nature of the patent and the very limited earnings history of the company. Specifically, with respect to your recommended procedure of "ascribing to the issuances of stock a value based upon capitalization of earnings (at a 10 per cent rate) for the applicable fiscal year," while admittedly a ten-to-one price-earnings relationship has long been recognized as a bench mark in judging the market value of stocks, other factors may justify a stock selling on the basis of a higher or lower price-earnings ratio. While a

[1] In this connection, see *SEC Accounting Series Release No. 73: The Thomascolor Case* which appeared at p. 83 *et seq.* of the January, 1953 issue of *The Journal of Accountancy.*

10 per cent capitalization rate or ten-to-one ratio still seems to be a key yardstick when it comes to putting money on the line, there apparently is nothing as yet to demonstrate in the circumstances of this case that money has been or will be consistently advanced on this basis. Although you will note on pp. 292-4 of *Montgomery* (*op. cit.*) that the fair value of a patent acquired in exchange for capital stock *may* be determined "by capitalization of royalties obtained from the patent, or by capitalization of other earnings attributable to it," we nevertheless would feel comfortable in using the formula which you propose *only* if there were a more extensive demonstrated earnings history.

Accordingly, our personal conclusion is that the patent should be recorded in the accounts of the rather recently-organized corporation in terms of cost to predecessor, i.e., in terms of the transferor's basis. Such carrying value would be supported by actual cost expenditures made to develop the patent. Especially would we favor use of the transferor's cost if the latter is affiliated with the transferee or if the transaction is not otherwise at arms-length.

To the extent, if any, that the par or stated value of stock actually issued exceeds the cost so recorded, "stock discount" or "excess of par value over cost ascribed to patent" would have to be reflected. However, although we cannot cite authority therefor, we personally would not be averse to eliminating any such discount by charging same against accumulated earnings or by applying dividends to which the transferor became entitled in ordinary course to elimination of any such discount. In effect, the transferor's shares would become fully paid by applying his share of demonstrated earnings from the patent.[2]

We believe special consideration should be given to the following passage from Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962, at p. 39) which raises the question whether patent rights of purely speculative value are to be deemed "property" within the purview of certain corporate statutes, and fundamentally,

[2] The following two items which appeared in Carman G. Blough's column are relevant to the problem in important respects, viz.:

1. "Treatment of Promotional Shares Held in Escrow" (*The Journal of Accountancy* for August, 1953, pp. 221-2).
2. "Transfer of Patent Rights for Capital Stock" (*The Journal of Accountancy* for May, 1954, pp. 607-08).

whether such patent rights represent a legally acceptable consideration for the issuance of shares, viz.:

> It must be borne in mind, in connection with the issuance of shares for property, that certain types of consideration which at first blush might be classified as "property" may not be so regarded by the courts. Patent rights of a purely speculative value and so-called secret processes or formulas have been held to have no "substantial" value, and therefore not to be "property." A secret process may be merely a method of doing something, known to an individual whose knowledge of it, when acquired by the corporation, is not "property. . . ." (See 11 *Fletcher, Cyclopedia of Corporations,* permanent ed., sections 5188-93.)

Inquiry **390**

Stock issued for licensing agreement based on patent application covering unproved electronic mining equipment

"I have been asked to issue a report on a corporation for the purpose of registering its securities with a state agency (not SEC) for public sale.

"This corporation has total assets of approximately $655,000, consisting of a small amount of cash, accounts receivable and property and a licensing agreement in connection with a patent application, carried at $650,000. 650,000 shares of $1 par value stock were issued in exchange for this licensing agreement. Total outstanding stock consists of 668,000 shares, 18,000 of which were sold at par to one stockholder for cash.

"The corporation was organized in August of 1957 for the sole purpose of acquiring the licensing agreement from two of the organizers, who in turn had acquired the agreement from a third party at $1 cost. The main promoter (of the two original organizers) is out of the picture at this time and the stock which he acquired has been distributed by him to various parties for considerations unknown to me in most cases. 100,000 shares were given by him to the original owner of the patent applications behind the licensing agreements. This man is now president of the corporation and in active control of its management.

"The devices which are covered by the licensing agreement are unproved electronic mining equipment, and it is obvious to everyone, including the present management of the corporation, that the valuation placed upon the licensing agreement is totally unrealistic. I realize that I must express an adverse opinion on any financial statement carrying a $650,000 valuation for this agreement. Obviously if the agreement were written down to a nominal value, there would be a large deficit, but present management is anxious to do anything necessary to disclose the true situation and present a realistic statement.

"I shall appreciate your comments as to how such a situation should be handled. Do you agree that an unqualified opinion cannot be given by me unless the licensing agreement is written down to a nominal value of, say, one dollar?"

Our Opinion

Under the circumstances described in your letter (patent pending, electronic mining equipment unproved, licensing agreement acquired by organizers for $1), it is our opinion the licensing agreement should be written down by $649,999 and stock discount in that amount reflected in the balance sheet. We agree with you that you would have to express an adverse opinion on any financial statement carrying a $650,000 valuation for the licensing agreement. If representations are made in the statements at this juncture that the licensing agreement had a cost, or has a value, of $650,000, the corporation would obviously be open to charges that its stock or capital is "watered."[1]

Inquiry **391**

Stock for stock acquisition of options to purchase going business and undeveloped real estate

"We have a transaction on behalf of one of our clients which will

[1] Paton's *Advanced Accounting* (Macmillan Co., N.Y., 1949) at pp. 506-09 and 515-22 contains a helpful discussion relevant to the foregoing.

require a decision as to presentation on the statement of financial condition as of December 31 of this year, and since the client is registered with the Securities and Exchange Commission, it will naturally require presentation on Form 10-K.

"The problem is briefly outlined as follows:

"Corporation H, a holding company, recently acquired all of the outstanding common voting stock of two subsidiary corporations, referred to as Corporations X and Y. Each of these subsidiary corporations had recorded assets and net worth of approximately $250,000, or a total of $500,000. Corporation H acquired all of the outstanding stock of Corporations X and Y by the issuance of its own common stock, having an over-the-counter market price on the date of acquisition totaling $2 million. The acquisition was treated as a nontaxable exchange.

"The only assets of substance acquired through the acquisition of the capital stock of Corporations X and Y were earnest money deposits in an escrow related to an option held by Corporations X and Y to purchase certain undeveloped real estate for an additional sum of approximately $4 million, and a going business for approximately $500,000.

"Immediately after the acquisition of the capital stock of Corporations X and Y, these two subsidiaries were dissolved and their net assets taken over by Corporation H. Corporation H thereupon assigned or sold its rights under the options to acquire approximately $4 million in unimproved real estate to its wholly-owned subsidiary, Corporation S, for $1,000. Corporation H exercised its option to acquire the going business for approximately $500,000. Corporation S thereupon exercised its options to acquire the unimproved real estate by an additional expenditure of cash funds in the approximate amount of $4 million.

"Corporation H's stock has a par value of $1 per share, so that in both instances there was a substantial credit to paid-in surplus upon the issuance of its capital stock based on the book value of the assets acquired.

QUERY

"1. Should the excess cost of investment in the subsidiaries over the book value acquired (measured by the market value of stock issued) be reflected as an asset on the books of Corporation H?

"2. If so, what happens to this excess cost debit total, and how should it be labeled upon dissolution of Corporations X and Y?

"Our present thinking is that no excess cost should be booked, since it arises out of a non-taxable exchange, and represents intangible and somewhat questionable excess value attributable to the undeveloped real estate. Since this real estate cannot be held permanently for productive use, but can only be developed and sold (State S. & L. Regulations), a potential profit over the option purchase price will be booked in the course of ordinary sales."

Our Opinion

In our opinion, the recorded investment of Corporation H in the stock of Corporations X and Y should *not be* measured by the over-the-counter market price of Corporation H stock issued therefor.

We base the foregoing conclusion on two possible alternative grounds, viz.:

1. Either that the transaction is a "pooling of interests" rather than a "purchase" as those terms are defined and elaborated in *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957);
2. Or that, *even if* the acquisition of the stock of Corporations X and Y were construed to be a "purchase," the investment of Corporation H should be measured substantially in terms of the money assets taken over (i.e., the earnest money in escrow) rather than by the market value of the stock issued since, in the particular circumstances of this transaction, the money assets paid to obtain the options represent the "more clearly evident" value (see par. 8 of *A.R.B. No. 48*).

Based on the information contained in your letter, we are not in a position to state conclusively that the transactions in question meet substantially the criteria of a "pooling" set forth in *A.R.B. No. 48*. What we do know from your letter is that, in acquiring control of Corporations X and Y, stock was issued for stock. What we do not know is whether the former stockholders of X and Y ended up with something more than 5 per cent of the voting interest in the combined enterprise (see esp. par. 6 of *A.R.B. No 48*).[1]

[1] For cases treated as "poolings" even though former ownership interests of merged constituents ended up with *less than 5 per cent* of the voting interest in the combined enterprise, in the article "Distinguishing Between Purchase and Pooling," by S. R. Sapienza (June, 1961 issue of *The Journal of Accountancy*), see the references to the Cuno Engineering Corporation and Wen-Mac Corporation cases (2nd column, p. 39), and see also Table II on p. 40. Subsequent to the above exchange of correspondence, *Accounting Research Study No. 5, A Critical Study of Accounting for Business Combinations,* by Arthur R. Wyatt (AICPA, 1963), was published.

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If treated as a "pooling," the fair value of the stock issued becomes irrelevant as a basis for recording Corporation H's investment. The investment should then be measured by the book value of the underlying net assets which are to be taken onto the books of Corporation H upon dissolution of Corporations X and Y.

Inquiry **392**

Capital stock issued in consideration of assignment of land purchase contract

"Please advise as to the correct reflection on the books of a corporation when stock is issued for assignment of a contract. An individual had a contract to purchase land for $150,000 ($50,000 cash and $100,000 purchase money mortgage). The contract was assigned to a newly-formed corporation at a value of $40,000. The Board of Directors placed an evaluation of $190,000 on the land.

"Also, in the event that the contract is not fulfilled, what would be the appropriate entry on the corporation's books to reflect the fact that there is nothing in existence for which the stock was issued?"

Our Opinion

To get down to specifics, one must first take cognizance of the fact that, from a legal standpoint, the consideration for which shares are issued *must be of an acceptable type;* and despite the apparent leniency of the *Virginia Stock Corporation Act* in this respect (assuming a Virginia corporation), the legal question might well be raised whether this contract right to a future conveyance of land with correlative contractual obligation to pay for it constitutes consideration of an acceptable type. We have reference here to the *nature* of the consideration, not to its value or sufficiency as such.[1]

[1] See under "Consideration for Which Shares May Be Issued" at pp. 37-41 of Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962).

If we assume a thoroughgoing arms-length transaction between the corporation and the individual assignor of the contract, then *some* persons might contend that it would be acceptable to give asset status to the value of the "bargain-purchase right," if any, which inheres in the contract. Presumably, the value of such bargain-purchase right, if any, would be measured by the excess of the demonstrable fair market value of the land over the contract price for the land. As a general rule, however, accountants frown on giving explicit accounting recognition to alleged bargain purchases. Profit is recognized at point of sale, not at point of purchase – much less at the time of acquiring a contract right to purchase.

Even with the arms-length assumption as to corporation vis-à-vis individual, we personally would not be prepared to accept at face value the $190,000 value imputed to the land by the board unless, apart from the formal resolution, there is some objective or realistic evidence to support such value. For example, we would feel much more comfortable about the matter if the individual assignor could show several bona fide offers by unaffiliated third parties to take the land contract off his hands for a consideration indicating that such parties deemed $190,000 to be the current fair value of the land.

It should also be mentioned that if the $150,000 contract price represents a recently-negotiated purchase price, we would then be inclined to view the $190,000 value as arbitrary or whimsical in the absence of other convincing evidence of the higher value.

If, in fact, there is no "bargain-purchase value" to the contract, then if the stock is issued and the acquired contract is given asset status at $40,000, the corporation's capital would be "watered" to that extent. The proper accounting under such circumstances would be to eliminate the asset from the balance sheet and reflect *stock discount* in the amount of the par or stated value of stock issued, as an offset to the capital stock account.

Since a newly-formed corporation is involved and your letter does not refer to any other issued stock, the presumption on our part may not be unwarranted that the individual assignor in this case is the principal or sole stockholder at this juncture, and accordingly, *is* the board of directors. Under such circumstances, i.e., where the transaction is not arms-length, we personally feel the independent accountant should not lend his name to any statement giving asset status and imputing value to the contract acquired by assignment, that is to say, to any statement not reflecting stock discount. If there is little or no accounting authority for giving recognition to higher values upon an asserted bargain purchase, we believe it is even clearer that there is little or no accounting authority for recognizing an element of *appreciation* in effect in connection with a wholly executory contract.

In our view, the transaction in question is different in kind from the situation where a patently valuable consideration is paid for an option or for a "call" privilege. In the case in question, the stock of the newly-organized corporation has no tested fair value, and moreover, actual and possibly contingent liabilities are involved in the contract which would not be characteristic of an option (i.e., the optionee has no affirmative obligation to exercise the option, and accordingly, no obligation to pay the purchase price unless he exercises the option).

Incidentally, in the event that the contract is not fulfilled, and assuming that the contract *had* been given asset status, in our opinion, the asset should be reclassified as stock discount, and provision should be set up for estimated damages, if any, resulting from the default.

Inquiry **393**

Issuance of shares by newly-organized corporation for previously unrecorded goodwill and samples of proprietorship, and for promissory note

"I shall appreciate your help on an accounting problem which is confronting me. The facts are as follows:

"I have been contacted to perform an audit and to express an opinion on a corporation which has been in existence about three years and which has never been audited before. The company is in the business of printing advertising material and selling advertising specialties.

"There are two stockholders whom I shall designate A and B. A was in the business as a sole proprietor prior to the date the corporation was organized. A's books showed net assets of $21,000 when he offered to sell B a 40 per cent interest in the business for $24,000.

"B felt that the business was worth more than A's books reflected for two reasons: (1) A had accumulated a substantial amount of samples (which were not shown as assets on A's books); (2) goodwill was not shown on A's books.

"B agreed to buy a 40 per cent interest in the business for $24,000, and a corporation was organized. B gave the corporation his interest-bearing note for $24,000 and was issued 40 per cent of the stock. A transferred his assets to the corporation and was issued 60 per cent of the stock.

"Immediately after organization, the corporation's balance sheet appeared as follows:

Assets	
Net assets of A's proprietorship	$21,000
B's note	24,000
Samples and goodwill	15,000
Total	$60,000
Capital	
Capital stock (par value)	$25,000
Capital surplus (excess over par)	35,000
Total	$60,000

"Operations during the first three years of existence have been profitable, and prospects for the future look good.

"B has paid interest on his note each year, and this year he paid $4,800 on the principal.

"Inventories at the beginning and end of the year are small as compared with the balance of the year, and amount to only about 5 per cent of the current assets. I plan to verify the inventory at the end of this fiscal year (September 30), and worksheets are available on the inventory at the beginning of the year.

"My questions are as follows:

"1. Has the company 'purchased' samples and goodwill, and can these be shown as an asset at the value indicated?

"2. Can B's note be shown as an asset, or should it be deducted from capital?

"3. What effect will the lack of observation of the beginning inventory have on the expression of an opinion, and what comment or footnote, if any, will be necessary?"

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Our Opinion

1. Rather than putting it in terms of whether the company has "purchased" samples and goodwill, we would be inclined to describe it in terms of whether, in consideration for the issuance of 60 per cent of its outstanding shares to the former proprietor, the corporation, in addition to receiving net assets with a carrying value of $21,000 on the books of the predecessor proprietorship, also received valuable goodwill and samples having a useful service value.

If the samples (although an unrecorded asset on the proprietorship's books) had a useful future service value at the time of organizing the corporation, and would have required a current cost outlay if they had to be developed or acquired all over again, then we believe such samples might well be deemed good consideration for the issuance of stock and properly be given asset status on the recently-organized corporation's books.[1]

At this distance, we are in no position to vouchsafe that the value imputed to "Samples and goodwill" is fair. The $15,000 *may* be an arbitrary balancing figure, the parties plausibly reasoning: if $24,000 is to represent or measure B's 40 per cent interest in net assets, then $36,000 must measure A's 60 per cent interest; accordingly, if A is to transfer *recorded* net assets of the proprietorship having a carrying value of only $21,000 to the corporation, then we must *attribute* an additional $15,000 to the previously *unrecorded* (or previously expensed) samples and intangible goodwill in order to balance off A's capital contribution which is represented to be $36,000.

Some accountants might contend that whatever fair value was attributed to the tangible and intangible assets of the proprietorship in the course of A and B's arms-length dealings preceding the organization of the corporation, may also properly be imputed to such assets when transferred to the corporation. However, it seems to us such a view opens up all sorts of possibilities for *watering* the capital of the newly-organized corporation. If B's capital contribution-to-be is lim-

[1] Regarding the question whether goodwill is deemed to be a legally acceptable consideration upon issuance of stock, see *Corporate Practice*, by Israels and Gorman (Practising Law Institute, N.Y., 1962, at pp. 38-9). For excellent critical reviews of the accounting for goodwill, see also (a) "Section 21. Goodwill" at pp. 149-59 of *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1962), and (b) "A Good Look at Goodwill in Corporate Acquisitions," by Homer Kripke (in *The Banking Law Journal* for December, 1961).

ited to $24,000 and B is to be issued 40 per cent of the capital stock *in any event,* then most any figure could be ascribed to A's capital contribution (particularly to the goodwill transferred), possibly building up the capital surplus unjustifiably. Perhaps it should be stated here that even if one assumes that goodwill in the particular state jurisdiction involved may be deemed a legally acceptable consideration for the initial issuance of shares, nevertheless, there is still the stock-watering problem which has to be faced, i.e., the problem of properly measuring such goodwill.

In view of the foregoing, we personally would feel much more comfortable if no goodwill (or goodwill at only a nominal amount) were recognized *in the accounts* at the inception of this corporation. We personally believe the concept of "purchased" goodwill should not apply in the case of a newly-organized corporation which has made no direct cost outlay for the intangible as the result of an arms-length transaction. The fact that the transaction is characterized by a *continuance* of beneficial interest or ownership is, in our opinion, a controlling consideration. As for the "samples," if, as stated previously, they have a useful future service value, we personally would have no objection to reinstating, in the corporation's accounts, the portion of the previously expensed costs of developing same which is deemed to represent excessive amortization, reduced, however, by an allowance for non-tax-deductibility thereof in the future.

2. Regarding your second question, we believe we should emphasize at the outset that in a number of states promissory notes are not deemed to be acceptable consideration for the issuance of shares, either as a result of judicial decision or statutory proscription.[2] You may want to obtain the opinion of counsel on this point insofar as it may or may not apply in the client's state of incorporation.

You will note that *Montgomery* (*op. cit.* footnote 2, pp. 186 and 424) indicates that, in certain circumstances, receivables arising from

[2] For references to this point as well as to other aspects of this second question, see material cited in footnote 1, and see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 186, 413, 414, and 423-4. It is of interest to note that the recently-enacted *New York Business Corporation Law* which became effective September 1, 1963, provides that shares may be issued for property, tangible or intangible, and for labor or services performed for the corporation or in its formation (Sec. 504(a)), but they may not be issued for services yet to be performed (Sec. 504(b)). *The obligation of the subscriber to pay for his shares, even if evidenced by his note, does not constitute payment* (Sec. 504(6)), and with two exceptions (Sec's 505(d), (e), and (f)), *the corporation may not issue shares before receiving full payment therefor* (Sec. 504(h)). (*our emphasis*)

subscriptions to capital stock should be treated as a deduction from capital stock subscribed, or in other cases, only the cumulative installment amounts paid in on stock should be reflected in the capital section.

In your client's situation, we believe the balance of the note receivable from B may be shown as an asset if promissory notes are legally acceptable as consideration upon issuance of stock. If not, we would be inclined to reflect the balance to be paid in on the note as stock discount deducted from the sum total of capital stock and capital surplus, with a footnote keyed to the discount item disclosing that the corporation holds an interest-bearing note covering the amount of the discount which is expected to be paid in ordinary course within a period of X years.

3. Regarding your third question as to effect of lack of observation of beginning inventory on your expression of an opinion, on grounds of *immateriality*, and assuming that you are satisfied on all other significant aspects, we believe you may properly express an unqualified opinion on the client's statements.

Inquiry **394**

Issuance of stock for executory contracts, by newly-organized corporation

"Within the near future I will begin the initial audit of a corporation organized for the purpose of acting as a manufacturer's representative and as an engineering consultant. This company presently represents several manufacturers of electrical controls. It is a close corporation having only two stockholders and a limited number of key employees.

"The problem on which I would appreciate your advice concerns the valuation and statement presentation of manufacturer's representative contracts included in the assets of the corporation. These contracts were formerly the property of the major stockholder and were assigned to the corporation as part of the payment for his capital stock. At the time of incorporation they were recorded on the records at a value representing approximately 85 per cent of the par value of the capital stock issued to this stockholder. The stockholder holds 75 per cent of the outstanding stock.

"In order to provide you with an insight as to the nature of this problem, I will briefly describe these contracts. They are open-end contracts with no stated expiration dates but with a clause permitting either party to terminate after giving the other party thirty days notice. None of the contracts contain a minimum guaranty of commissions to be received by the holder, and each contract is not transferable without the prior approval of the remaining party. The stockholder who assigned the contracts (with the manufacturer's approval) had held the contracts for only six months prior to the transfer and had established sound business contacts within the territory during the six-month period. They are presently valued at the estimated amount of commissions for one year. Assuming that a value is determined, how should they be amortized?"

Our Opinion

In our opinion, there may be a much more basic problem in the case described than the problem of valuation and amortization of the manufacturer's representative contracts, viz., the problem whether such contracts are from a legal standpoint both *adequate* and *sufficient* consideration for the par value shares issued. If such contracts under the statutes and judicial interpretations of the state of incorporation are not deemed to be "property" of a type constituting *adequate* consideration upon the original issuance of stock therefor, then we do not believe the contracts should be given asset status, and stock discount must be reflected. Assuming such contracts pass the test of adequate consideration, i.e., are held to be a legally *acceptable* medium of payment for shares issued upon organization, then a further question arises whether the value of such contracts is *sufficient* consideration for the par value shares issued. The extent to which the fair value of the contracts is less than the par value of the shares issued therefor, would measure the amount of stock discount involved. It seems to us a competent attorney's opinion on whether the contracts in question constitute adequate *and* sufficient consideration for the shares in the state of incorporation should be obtained.

From the standpoint of generally accepted accounting principles, *we do not believe it is customary or proper to recognize prospective revenues to be received under an executory contract as an admissible* *asset.* Also intangibles are not generally recognized as an asset unless purchased in an arms-length transaction. *Accounting Research Bulletin No. 43* (AICPA, 1953, at p. 38) states that "In the case of non-cash acquisitions, as, for example, where intangibles are acquired in exchange for securities, cost may be considered as being either the fair value of the consideration given or the fair value of the property or right acquired, whichever is the more clearly evident." In the case of this newly-organized, closely-held corporation, the stock has no proven fair value and the nature of the contracts is such (power to terminate with thirty days notice, no minimum guaranty of commissions, restriction on transferability) that their value, to say the least, is unproven and speculative.

We note in Prentice-Hall, Inc.'s *Corporation Report* service that "One state (Michigan) provides that only such property as can be sold and transferred by the corporation and as shall be subject to levy and sale on execution, or other process against the corporation, shall be accepted in payment for stock." It is also stated (*ibid.*) that "Property not readily applicable to the payment of a corporation's debts cannot constitute consideration for issuance of stock." On the other hand, the service states in another place a holding that "The anticipated profits of an executory contract may give commercial value to the contract so that an assignment thereof may be accepted in payment for stock." The foregoing statements are quoted merely to indicate that there is or may be a critical legal problem in the case in question.

If it is decided that the contracts in question are admissible within the family of assets and value is assigned, it seems to us that amortization of the carrying value, if there is to be any amortization, would have to be rationalized under the terms of either par. 6 or 7 or par. 8 at pp. 38-9 of *A.R.B. No. 43.*

Regarding the Prentice-Hall reference to "commercial value . . . of the anticipated profits of an executory contract," it should first be noted that the reference is to "profits," not gross revenues. Query then whether the "year's commissions" in the case at hand should be discounted for the estimated costs involved in earning or realizing such commissions, including taxes applicable to the net commissions? Theoretically, should there be a further discounting of the net commissions to reduce them to their present value? Finally, should the executory contracts be further discounted or reduced to recognize the fact that the recorded value thereof is not deductible for tax purposes?

Also, if the unrealized net commissions as further discounted are not to be reflected in the accounts a second time, i.e., once in the capital stock account and again in earned surplus, query whether amortization of the carrying value of the contracts against commissions actually earned is mandatory? We ask these questions with serious purpose, for we personally have definite reservations about the bona fides of the "asset" in question.[1]

Inquiry **395**

Determination of amount of stock to be issued in exchange for installment obligations

"One of my clients is transferring a number of installment obligations to a closely-held corporation tax-free under the provisions of Sec. 351, IRC. The tax basis to the corporation, according to Reg. 1.453-9(b)(2) is 'excess of the face value of the obligation over an amount equal to the income which would have been returnable had the obligation been satisfied in full.'

"Please assume the following facts, for the sake of simplicity: Face of contracts \$10,000; unreported income at date of transfer \$4,000. It is probable that the taxable income of the acquiring corporation will not exceed \$25,000, with a consequent tax rate of 30 per cent, although higher earnings cannot be entirely ruled out.

"It would seem reasonable to issue stock in exchange for these obligations in the amount of \$8,800, allowing provision for a foresee-

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[1] For a discussion of "Consideration for Which Shares May Be Issued," see pp. 37-41 in Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962).

For other references of possible interest, see the following:

a. "Tax Aspects of the Sale or Exchange of Contracts," by A. R. Cowan
b. "How to Value Dealer-Distributor Franchises," by J. C. Bruton
(In January, 1947 and February, 1951 issues, respectively, of *Taxes — The Tax Magazine*)

If you have not already consulted the "services," Prentice-Hall, Inc's. *Federal Taxes* deals with the Valuation of Property, including Intangibles. Cases involving valuation of contracts are cited, and the subject "Valuation of Contracts" is discussed. The Commerce Clearing House, Inc.'s *Standard Federal Tax Reporter* also has sections dealing with "Valuation of Contracts"; "Valuation of Corporate Assets Acquired for Stock"; and "Valuation of Intangibles."

able tax liability of $1,200, based on 30 per cent of the $4,000 income to be reported by the corporation.

"The following condensed and incomplete journal entry sets up my dilemma:

Dr. Contracts Receivable	$10,000	
(?)	4,000	
Cr. Capital Stock		$8,800
Deferred Income		4,000
Reserve for Income Taxes on D/I		1,200

"Will you please let me have your opinion on the proper accounting treatment of the transaction, recording the investment on the books of the acquiring corporation?"

Our Opinion

In our opinion, the acquiring corporation should record the total contract prices of the installment obligations acquired as Contracts Receivable. The present value of the series of payments to be received under the contracts, i.e., the amount for which the installment obligations could be discounted, reduced by deferred income tax applicable to the difference between the tax basis and the present value of the obligations, should be deemed the consideration received for the capital stock issued, and accordingly, the stock should be recorded in terms of such consideration. Furthermore, the difference between total contract prices recorded and the present value of the contracts should be set up as unearned interest (discount, time-price differential). The latter account, for balance-sheet purposes, should be reflected as an offset, i.e., a deduction from the Contracts Receivable. When and as portions of the deferred income are recognized as earned, provision for the taxes applicable thereto should be made.

Thus, assuming that the tax basis both to transferor and transferee is $6,000 ($10,000 face amount of contracts less $4,000 of unreported income), that $3,000 of the unreported income represents the difference between the transferor's cost of merchandise sold under installment contracts and the immediate cash purchase price of such merchandise (or present value of the installment obligations), and that the remaining $1,000 of the unreported income measures the time-price differential or loading charge to customers for the privilege of deferring their payments, then we believe the following journal entry would be proper:

Dr. Installment Contracts Receivable	$10,000	
Cr. Unearned Income		$1,000
Deferred Income Tax		900*
Capital Stock (or Capital Stock and Paid-In Surplus		8,100

* 30 per cent of the *excess* of income to be reported for tax purposes over the amount recorded as deferred income

Another staff member with whom we discussed your question was of the opinion that the following entries are proper, viz.:

1. Assuming that the installment method of accounting was used both for book and tax purposes by the transferor –

Dr. Contracts Receivable	$10,000	
Cr. Unrealized Profit		$4,000
Capital Stock		6,000

2. Assuming that the installment method of accounting was used for tax purposes but the accrual method was used for book purposes by the transferor –

Dr. Contracts Receivable	$10,000	
Cr. Deferred Income Tax		$1,200
Capital Stock		8,800

Although the foregoing have the appeal of simplicity, we personally have some reservations concerning same. Assuming that under the first presentation Unrealized Profit would be shown as an offset to Contracts Receivable, then the net amount of the latter would reflect the tax basis of the installment obligations which we assume is less than present realizable value. Under the second presentation, although the Contracts Receivable would be offset or "discounted," so to speak, to the extent of the taxes expected to be paid on prospective income reportable for tax purposes, nevertheless the Contracts Receivable would not be stated at their present realizable cash value;

and Capital Stock would not be stated in terms of the current fair value of the consideration paid in for the stock.

If, immediately after transfer of the obligations, the closely-held corporation discounted them with a financing institution for what we have previously assumed represents the present realizable cash value of the obligations, the corporation would receive $9,000. After deducting the $6,000 basis therefrom, the corporation would have a $3,000 profit or gain presumably subject to either a $900 (30 per cent) or a $750 (25 per cent) tax. If the $900 tax which the acquiring corporation would pay in ordinary course is used, then the net proceeds realized after taxes by the corporation would be $8,100 which, under the treatment we have recommended, represents in effect the net carrying value assigned to Contracts Receivable as well as the amount reflected as paid-in capital.

Inquiry 396

Stock issued for stock; stock issued for notes; notes issued for notes — recorded at directors' valuations

"We have an investment company, dealing mainly in real estate properties, which is purchasing investments at higher than their par or face value by delivery of capital stock of the company and recording the cost of such purchases at a value higher than the par value of capital stock issued therefor and very much higher than the par value of the securities acquired.

"Here are the main highlights:

"1. Our Company (we shall call it thus henceforward) has issued 302 shares of its capital stock of $1,000 each, par value, at various intervals, for cash.

"2. Our Company has issued 100 shares of its capital stock ($100,000 par value) in exchange for 8,000 shares in A. B. Building Company, a majority-owned subsidiary company, which shares have a par value of $1 each. The cost of the 8,000 shares has been recorded on the books of Our Company at $600,000, the difference of $500,000 being credited to Paid-In Surplus.

"3. Our Company has issued 100 shares of its capital stock ($100,000 par value) in exchange for 8 per cent promissory notes due on demand issued by C. D. Building Company, with a face value totaling $200,000. The cost of these promissory notes has been recorded on the books of Our Company at $200,000, the difference of $100,000 being credited to Paid-In Surplus.

"4. Our Company has issued a 5 per cent Note Payable, due in 1965, with a face value of $500,000, in exchange for a 7 per cent Note, of same face amount, due 1960, issued by C. D. Building Company.

"5. Our Company has issued 100 shares of its capital stock ($100,000 par value) in exchange for a total of 14,000 shares in various companies, having a par value of $14,000. The cost of such 14,000 shares has been recorded on the books of Our Company at $400,000, the difference of $300,000 being credited to Paid-In Surplus. Here is a detail of this transaction:

Issuer	*No. of shares*	*Par value of shares*	*Valued on books of Our Co.*	*Par value of shares issued by Our Co.*	*Amount credited to Paid-In Surplus*
E.F. Bldg. Co.	7,000	$ 7,000	$250,000	$ 62,500	$187,500
G.H. Bldg. Co.	5,000	5,000	100,000	25,000	75,000
J.K. Bldg. Co.	2,000	2,000	50,000	12,500	37,500
		$14,000	$400,000	$100,000	$300,000

"6. Our Company sold its investment in G. H. Building Co. and J. K. Building Co. for cash at its recorded value of $150,000, but the amounts credited upon purchase thereof to Paid-In Surplus ($75,000 and $37,500) remain in Paid-In Surplus.

"7. Our Company declared and paid a dividend in cash of 100 per cent of its net profit for the year. There was no earned surplus.

"8. Our Company declared and paid dividends out of Paid-In Surplus as follows:

Stock dividend –	$100,000
Cash dividend –	200,000
	$300,000

"We have carried out the necessary audit procedures, including confirmation or examination of securities and examination of financial statements, audited by other firms of public accountants, of all the companies invested in, with satisfactory results. As a consequence, we are prepared to give a 'clean' certificate, but with adequate disclosures on the face of the balance sheet, as follows:

Assets

CURRENT ASSETS			
Cash in banks		$ 254,500	
Interest receivable		5,000	$ 259,500
INVESTMENTS			
Based upon Directors' valuation as paid for by the issue of capital stock of the Company with a par value of $162,500, with a premium thereon of $287,500 credited to Paid-In Surplus			
C.D. Bldg. Co. – 8% demand notes	$200,000		
E.F. Bldg. Co. – 7,000 common shares	250,000	$ 450,000	
At cost as paid for by the issue of 5% note payable by the Co. – C.D. Bldg. Co. – 7% note due 1960		500,000	950,000
INVESTMENT IN SUBSIDIARY COMPANY			
A.B. Building Co., based upon Directors' valuation as paid for by the issue of capital stock of the Company with a par value of $100,000, with a premium thereon of $500,000, credited to Paid-In Surplus			600,000
			$1,809,500

LIABILITIES AND CAPITAL

CURRENT LIABILITIES			$ 7,500
5% NOTE PAYABLE DUE 1965			500,000
CAPITAL STOCK AND SURPLUS			
Capital stock			
Issued and outstanding, 702 shares of $1,000 each, par value		$ 702,000	
Paid-In Surplus			
Amount paid-in over par value of capital stock issued, less dividend paid therefrom, $300,000		600,000	
		$1,302,000	
Net income for the year	$5,500		
Less cash dividend paid	5,500		1,302,000
			$1,809,500

"We would appreciate your opinion on the following:

A. Is the accounting procedure correct?
B. Is the balance-sheet presentation correct?
C. Does the balance sheet show the necessary disclosures?
D. Based on all the foregoing, can a 'clean' certificate be rendered?"

Our Opinion

A. We suppose that in asking whether the "accounting procedure" is correct, you have principal reference to the procedure of "purchasing investments at higher than their par or face value by delivery of capital stock of the company and recording the cost of such purchases at a value higher than the par value of capital stock issued therefor and very much higher than the par value of the securities acquired." It would be unwise for us at this distance to attempt to state that the accounting procedure followed is or is not correct. The general principle applying to so-called non-cash transactions (property acquired for stock, stock for stock, etc.), is stated in par. 4, p. 38, of *Accounting Research Bulletin No. 43* (AICPA, 1953). This general principle is also reiterated and briefly discussed at p. 245 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957).

Whether the investments are fairly stated or are recorded at whimsical or arbitrary amounts is entirely a matter of judgment applied within the framework of the aforementioned general principle *if* certain of the transactions may properly be construed as *purchases* — otherwise, within the framework of principles and procedures employed when accounting for a *pooling of interests.*

When stock is exchanged for stock, the par values of the respective issues may be significant or completely irrelevant for the purpose of measuring the "cost" of the securities acquired. There would appear to be a serious question here whether certain of the investments should be measured in terms of the book value of the net assets underlying the stock acquired, provided that the carrying amounts comprising such net assets are stated in conformity with generally accepted accounting principles. You state that you have examined or analyzed to your satisfaction the financial statements audited by other firms of public accountants, i.e., the statements of companies whose securities the client has acquired. Evidently you feel that what you found in the statements gives some substance or support to the directors' valuation of the investments.

Based only on the internal evidence offered by your letter, however, we would be inclined to question the fairness of amounts recorded as "cost" of the investment in the case of certain transactions described. Although the directors may have a justifiable explanation at hand, it is difficult for us to reconcile the second, third, and fifth transactions set forth in your letter, viz.: in each case the client issued its own shares having a par value of $100,000, but in recording the consideration, i.e., the securities received therefor, such variant "costs" as $600,000, $200,000, and $400,000, are reflected in the accounts.

B. and C. Apart from the crucial questions raised above relating to fairness of the values ascribed to transactions, it seems to us that the balance-sheet presentation, from the standpoint of adequacy of disclosure, is quite satisfactory. However, we believe the presentation would be improved if the explanation under "Paid-In Surplus" were changed to read: "Amount assigned to issued shares in excess of their par value based on Directors' valuations, less cash and stock dividends totaling $300,000 paid therefrom."

D. In the present stage of the development of auditing, we are not aware of any authoritative pronouncement (going beyond a requirement of disclosure) which clearly indicates the CPA's reporting responsibility in situations involving, or possibly involving, watered stock.

However, in our opinion, it is incumbent on the independent accountant to satisfy himself that directors' valuations are not arbitrary or capricious. He should scrutinize such valuations to determine whether they are based on some reasonably objective or conventionally objective valuation criteria. If, on balance, he concludes that directors' valuations are arbitrary and not referable to acceptable valuation or accounting bases, he should qualify his opinion—or if his exceptions involve such material amounts, and information available to him indicates that representations in the statements are highly subjective or based on tenuous data, he should express an adverse opinion, and disclose all the substantive reasons why[1]—since the most significant phrase in the accountant's opinion is "presents fairly." Once a CPA deems a basis insupportable, he may not disregard that fact; an unfair representation in a financial statement is not cured merely by disclosure of *some* basis therefor.

Inquiry 397

Resale of treasury shares combined with issuance of additional shares

"I am writing for an opinion. At present the corporation has the following situation:

Common Stock par value $10, authorized 25,000 shares	
Capital Stock issued and outstanding 12,150 shares	
Capital Surplus (arising from excess received upon sale of stock over par value of stock)	$ 529
Treasury Stock 450 shares at cost	$8,388

"At present the company is issuing 1950 shares of common stock

[1] See par's 9-12 dealing with "Adverse Opinion" in *Statements on Auditing Procedure No. 32, Qualifications and Disclaimers* (AICPA, 1962). Cf. *S.A.P. No.* 33 (AICPA, 1963), par's 12 and 13 at p. 59.

at $9.54 per share. The problem now is the accounting treatment for the issuance of this stock:

"1. If the 450 shares of treasury stock are to be considered a part of this issuance, would the difference between the cost of the treasury stock and the par value be reflected in capital surplus?

"2. If treasury stock is not to be issued, should the difference between the issuing price and par value be reflected in capital surplus?

"3. If treasury stock is not to be issued, would it be proper to credit capital stock for the issue price?

"From above items 1 and 2, it is obvious that capital surplus account would reflect a debit balance, which would be most unusual and probably result in a change in terminology, such as capital deficit. It would appear to me that item 3 would be more proper since it would be more informative and provide adequate disclosure. The disadvantage would be that the capital stock account would indicate some stock sold at par value and other stock at less than par value."

Our Opinion

Treasury shares are *issued but not outstanding* shares. If no treasury shares are distributed in connection with the corporation's plan to increase its outstanding shares by 1950 shares in consideration of the payment of $9.54 per share, then in our opinion, the corporation would have to record stock discount of $897 [$19,500 less (1950 times $9.54) or $18,603; stock carries par value of $10 per share and newly-*issued* stock must be "fully-paid"]. If treasury shares are not to be distributed, we believe it would be improper to limit the credit to the capital stock account to the total issue price. Such a treatment would understate the corporation's legal or stated capital respecting such shares.

On the other hand, if the transaction is consummated by distributing 1500 newly-*issued* shares and 450 treasury shares, then in our opinion, the corporation should record stock discount of $690 applicable to the 1500 shares; and the difference between the total cost of the treasury stock ($8,388) and the total consideration received therefor ($4,293), that is, $4,095, should be charged to capital surplus to the extent that such surplus is applicable or traceable to the treasury shares resold, with the remainder being charged to earned surplus.[1]

The following passage from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, p. 390) indicates other possible refinements in treatment of a loss on the sale of treasury stock, viz.:

> Loss on the sale of treasury stock may be charged to paid-in surplus arising from similar transactions; if no such surplus exists the loss should usually be charged to earned surplus. It would be improper to charge a loss on the sale of treasury stock to paid-in surplus arising from issue of shares outstanding,[2] but it would be proper to charge such a loss to paid-in surplus arising from a class of stock previously retired through purchase or redemption.

If, by any chance, the 1950 shares are being sold to present stockholders proportionate to their present holdings, the same amount of capital would be obtained and the reflection of stock discount could be avoided by issuing only 1860 shares for a consideration of $10 per share; or, if it was planned to issue the 1950 shares to a single stockholder, perhaps he could be persuaded to subscribe to 1860 shares at $10 per share with no possibility of further assessment on the shares even though he would retain a slightly lower percentage interest in the corporation. If the entire amount of a loss on resale of a corporation's own stock may be charged against paid-in surplus (see footnote 1), then the client in question might well give consideration to creation of a reduction surplus (i.e., additional paid-in surplus) of some $12,600 by formally reducing the par value of its stock from $10 to $9. If 1950 shares (including the treasury shares) were then sold for $9.54 per share, more than sufficient paid-in surplus would be available to absorb the $4095 loss on resale of the treasury stock, and the 1500 newly-issued shares would be "fully-paid and non-assessable."

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1 This latter treatment, although commonly employed, does not square with par's 7 and 10, at p. 14 of *Accounting Research and Terminology Bulletins* (AICPA, 1961) where the Committee on Accounting Procedure states with respect to differences arising upon purchase and retirement or upon purchase and resale of a corporation's own stock, that "such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. . . . (the committee) does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account)."

2 Cf. footnote 1.

INQUIRY: 397

Inquiry 398

Recapitalization and reclassification, followed by donation back and subsequent resale of shares

"Will you please give us your opinion on the proper entries to record a recapitalization as set forth below?

"This company was capitalized with 100 shares of no-par stock. Fifty-one shares were issued for $5,538.35. This capitalization remained constant for approximately twenty-four years. During 1957 the certificate of incorporation was amended as follows:

> The total number of shares that may be issued by the corporation shall be 100,000 all of which are to have a par value of Ten Cents ($.10) per share and which are to be of the same class and are to be Common Stock.

"The terms of the change of shares were as follows:

> Each of the 51 shares of Common Stock without par value of the corporation heretofore issued shall be and hereby is reclassified into 1,960.755 shares of the Common Stock, par value $.10 per share, of the corporation, making a total of 99,999.525 shares of the Common Stock, par value $.10 per share, of the corporation presently issued and outstanding. Each of the 49 shares of Common Stock without par value of the corporation heretofore authorized but not heretofore issued shall be and hereby is eliminated.

"When this charter amendment had been accomplished the four original stockholders, then holding 92,000 shares of $.10 par stock contributed 32,999.525 to the corporation for cancellation. The corporation thereupon sold 25,000 shares to a fifth party for $1.80 per share or a total of $45,000 cash."

Our Opinion

In our opinion, 55,383.5 of the 99,999.525 new or reclassified shares issued and outstanding immediately after executing the charter amendment may be deemed "fully-paid" on the basis of the past consideration, i.e., the original paid-in capital of $5,538.35, received upon issuance of the 51 old shares. Assuming no further direct contribution of capital was made by the holders of the 51 old shares, then in order that the remainder (44,616.025) of the new shares issued and outstanding be deemed "fully-paid," we believe the following entry should be made:

Dr. Earned Surplus	$4,461.60	
Cr. Capital Stock (issued and outstanding)		$4,461.60

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, see pp. 393-4) states the following:

> Donated Surplus. — When a corporation's own stock (issued fully paid and nonassessable) which has been reacquired by donation is subsequently disposed of, the proceeds of the sale become donated surplus.
>
> Until sold or retired, donated treasury stock may be entered on the books at no value or at a nominal amount of $1, with an offsetting credit to donated surplus. The latter account should be adjusted as the shares are subsequently disposed of.

On the basis of the foregoing, we would be inclined to record the donation of 32,999.525 shares back to the corporation as follows:

Dr. Treasury Stock	$1.00	
Cr. Paid-In (Donated) Surplus		$1.00

Upon subsequent sale of 25,000 of the treasury shares, we believe the following entry would be proper:

Dr. Cash	$45,000.00	
Cr. Paid-In (Donated) Surplus		$45,000.00

The remaining 7,999.525 treasury shares should, if not formally retired, continue to be carried in the balance sheet at the nominal valuation of $1. When and if formally retired, the following entry should be made:

Dr. Capital Stock	$799.95	
Cr. Paid-In Surplus		$798.95
Treasury Stock		1.00

It goes without saying that the balance sheet first reflecting consummation of the recapitalization or reclassification of capital stock would indicate the new par value of the common shares, and the number of such shares authorized, issued and outstanding, and in treasury. A footnote to such balance sheet should also succinctly disclose the nature and terms of the recapitalization.

Inquiry **399**

Old stock not turned in for new, upon recapitalization — balance-sheet presentation

"We would appreciate your comments on the proper method of presenting Capital Stock when there is a recapitalization involving an exchange of shares, and some of the old shares are never turned in for new shares.

"For example: Corporation has stock outstanding of 100 shares Common, par value $100, or $10,000 in Capital Stock account. By proper authorization, the old stock is called in and two shares of new stock at par value of $50 each are issued for each share of old stock. All old stock is turned in except ten shares, which results in $1,000 balance remaining in the old Capital Stock account.

"Is this disregarded in balance-sheet presentation and the Capital Stock shown as $10,000 (200 shares par value $50) on the assumption that the old will eventually be converted?

"Or do we carry two Capital Stock accounts (old and new)?"

Our Opinion

A practical solution to the financial presentation question you raise is indicated at p. 424 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), viz.:

> Unexchanged Stock in Recapitalization. — No hard and fast rule can be laid down for the presentation in the balance sheet of the unexchanged capital stock after the date of recapitalization. Usually the new capital stock should be shown as though all the old shares had been exchanged, with an explanatory statement

> either in the body of the balance sheet or as a footnote indicating the number of old shares still outstanding which for balance sheet purposes are assumed to have been exchanged and the basis upon which the exchange will be made upon receipt of the old certificates. Disclosure should be made of any dissents entered by stockholders who disapprove the merger or consolidation plans and who have applied to the courts for an appraisal of stock values, as provided by state statutes. The capitalization should not reflect the exchange of the shares held by dissenting stockholders.

It appears there is some analogy here to the question of the treatment of unclaimed dividends during the limitations period and the disposition thereof after the limitations period expires.

The usual treatment recommended at p. 424 of *Montgomery,* viz., showing the new capital stock *as though* all the old shares had been exchanged, with appropriate explanatory statement is, of course, the same as one of the treatments mentioned in your letter.

We see no great objection to carrying the two capital stock accounts (old and new), with appropriate explanation, provided any limitations period within which the exchange of shares must be effected, has not expired. This latter treatment certainly would portray the factual situation.

Another possible alternative, especially if a block of shares has not been turned in after a considerable time lag and several notices, would be to redesignate the old capital stock account as "Unexchanged capital stock still outstanding" – or other similar designation. In the balance-sheet description of the new stock the number of unissued shares reserved for exchange with old shares still outstanding might be indicated. If, at any point, it is determined that the rights of the old stockholders are forfeited, then the amount in the "Unexchanged capital stock" account should be reclassified as capital surplus.

Inquiry **400**

Recording of debentures and common stock issued as a unit; allocating underwriting commissions and other issue expenses to bonds and stock

"I would appreciate an answer or opinion on the following:

"A closely-held corporation registers with the Securities and Exchange Commission, and through an underwriter, offers the following securities for sale to the public. Prior to this offering there was no trading in the securities of the corporation.

"1. *Securities Offered for Sale*

A) 15,000 units of $1,500,000 principal amount of 6% Subordinated Debentures and 180,000 shares of Common Stock – $.25 par value. Each unit consists of $100 principal amount of Debentures and 12 shares of Common Stock which are separable following delivery. The subscription price is $160 per unit.

B) 100,000 shares of Common Stock ($.25 par value) offering price of $6.50 per share.

C) 37,500 Common Stock Purchase Warrants to be sold at $.01 each, evidencing the right of holders to purchase Common Stock at $6.50 per share. Such warrants to expire in 5 years.

"2. *Proceeds of Sale*	*Price to Public*	*Underwriting Commissions*	*Net Proceeds*
For 15,000 units			
Per unit	$160	16	144
Total	$2,400,000	240,000	2,160,000
For 100,000 shares			
Per share	$6.50	.65	5.85
Total	$650,000	65,000	585,000
For warrants			
Per each warrant	$.01		.01
Total	$375		375

"The net proceeds as indicated above is before deducting expenses estimated at $50,000, which includes reimbursement to the underwriters for certain expenses, including legal fees.

"Please advise how the above proposed transactions should be recorded on the books of the corporation. I am particularly interested in the following:

"A. Whether the dilution factor must be considered due to the offering of 100,000 shares of Common Stock at $6.50 per share, while at the same time 180,000 shares are presumably being offered at $5 per share when sold in units with the Debentures, principal amount of $100. Are the bonds to be recorded at the principal amount or are they deemed to be sold at a discount?

"B. On what basis should the Underwriting Commissions and other expenses be allocated to the Debentures?"

Our Opinion

In our opinion, the current bond issue price should be determined in accordance with the principles and procedure indicated at pp. 20.14-15 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956). Thereupon, the bonds issued should be recorded at face value, bond discount or bond premium being debited or credited as or if required, to bring the face amount to bond issue price as computed; and the difference between total bond issue price and gross proceeds of the sales of the 15,000 units should simultaneously be credited to equity accounts, i.e., $45,000 thereof being allocated to Capital Stock Outstanding with the remainder being credited to Paid-In Surplus.

We believe the $240,000 of Underwriting Commissions should then be allocated to Bond Issue Expense and to Stock Issue Expense in the ratios that total bond issue price and the above-mentioned difference attributable to equity bear, respectively, to the gross proceeds of the sale of the 15,000 units. The amount of Underwriting Commissions thus allocated to Bond Issue Expense should be amortized over the life of the bonds; the amount allocated to Stock Issue Expense should be charged off against Paid-In Surplus arising from the issuance.

Regarding the 100,000 shares issued at $6.50 per share, in our opinion, Cash and Stock Issue Expense should be debited $585,000 and $65,000, respectively, and correlatively, Capital Stock Outstanding and Paid-In Surplus should be credited $25,000 and $625,000, respectively. The $65,000 of Stock Issue Expense should then be charged off against Paid-In Surplus.

The 37,500 Common Stock Purchase Warrants, when and if sold for a consideration of $.01 each, should properly be reflected as Common Stock Warrants Outstanding. Since the amount involved is de minimis, we would be inclined to include the $375 in Paid-In Surplus with footnote disclosure of the fact that the latter includes a nominal amount representing consideration paid in for 37,500 Common Stock Purchase Warrants Outstanding.

As for the additional expenses of $50,000 mentioned in your letter, we believe such expenses should be allocated to Bond Issue Expense and to Stock Issue Expense in the ratios that total bond issue price as computed and total gross credits to equity accounts bear, respectively, to the total gross proceeds of all securities (bonds, stock, warrants) issued in connection with the offering.

Inquiry 401

Contracts for installment sale of stock, accounting and balance-sheet presentation

"I have a corporate audit client organized approximately two years ago, which presently consists of a parent corporation and four wholly-owned subsidiaries, three of which are engaged in the small loan business and one of which is a credit bureau. The parent company furnishes centralized machine accounting for the subsidiaries as well as central administrative control, and also furnishes working capital by loans to the subsidiaries.

"The parent company has set up its own securities sales organization and is handling all promotion expenses in selling its stock. It is contemplated that the stock sales will continue for some time, until sufficient capital is available to open four additional small loan subsidiaries. The stock offerings have been restricted to residents of the state of ...., and the company is not subject to SEC regulations, although it is subject to the control of the Investment Commissioners of the state of .... The present prospectus, approved by the Commissioners, offers capital stock with a par value of $10 per share at a price of $15 per share, and the prospectus reads in part as follows:

> This offering shall be handled by .... Acceptance Corporation itself, and salesmen shall be appointed under the direction of its officers. Expenses for the selling of the offer shall

> not exceed twenty per cent, which shall include all costs of selling, advertising, printing, legal services and other expenses. The net result to the company shall be $12 per share.

"At the present time the direct promotional expenses (sales commissions, brochures, etc.) plus administrative overhead allocated to the promotional effort, are running somewhat less than the 20 per cent limitation set forth in the prospectus.

"Stock sales are made either for cash, in which case stock is issued immediately, or under a stock sales agreement contract which provides that stock is not issued until the agreements are paid in full. We have opinion of counsel that the sales agreements are not considered subscriptions under law of the state of ....

"The company has set up stock sales transactions in the following manner (assuming a sales commission 'front-end load' for purposes of illustration):

	Dr.	Cr.
(A) *Contract Made (100 Shares – 1/3 down):*		
Stock Sales Contract Receivable	$1,000	
Cash	275	
Promotion Expense (Sales Commission)	225	
Paid-In Surplus (Stock Sales Contract)		$1,500
(B) *Cash Sale Made (100 Shares):*		
Cash	$1,275	
Promotion Expense (Sales Commission)	225	
Paid-In Surplus (Excess Over Par)		$ 500
Capital Stock		1,000
(C) *Other Promotion Expense:*		
Promotion Expense (brochures, etc., and allocated overhead)	$90	
Cash		$90

"When setting up a balance sheet based on the foregoing, the client company has followed the practice of classifying the total sales promotion expenses as 'organization expenses,' to be carried forward indefinitely.

"It appears to me that this treatment results in a distorted balance-sheet presentation when compared with a company which elects to employ an outside organization to market its original issue of securities. Would it be more proper, or permissible as an alternative treatment, to write off these promotion expenses against paid-in capital (or paid-in surplus) to reflect the actual proceeds of the issue to the company, with footnote disclosure of the facts?"

Our Opinion

In our opinion, irrespective of the fact that the client's salesmen or employees, rather than its selling agent, are selling the stock, it would be more proper to write off the costs of securing capital (stock issue costs) against paid-in surplus (in the case of cash sales of stock) or against "Capital paid in on installment sales of stock."[1]

Incidentally, one proper treatment of the stock sales contract type of transaction is to record all installment payments received as being in the nature of a deposit liability until the final payment is made and the stock concurrently issued. This treatment is based on the technical legal distinction drawn between a "subscription" and a "contract to purchase stock."[2] Your letter states that you have an opinion of counsel to the effect that the stock sales agreements are not deemed to be subscriptions under law of the state of . . . .

However, we also believe it acceptable to look upon the stock sales contract type of transaction as capital-in-process, so to speak. Accordingly, installment payments received may be credited tentatively to an account entitled "Capital paid in on installment sales of stock" which amounts would be reclassified as "Paid-in surplus" and "Capital stock issued and outstanding" when the final payment on the stock sales contract is made by the purchaser and the corporation concurrently issues the stock.

Adverting to your journal entries, we note that the company records the full balance receivable on the stock sales contracts together with two types of paid-in surplus depending on whether cash or installment sales of stock are involved. We personally have definite reservations about reflecting the balances receivable on stock sales contracts as an asset in the balance sheet, and furthermore, if the full amount of installment contracts for sales of stock is reflected as paid-in

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1 In support of such conclusion, see relevant pp. 384-5 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) and pp. 65-9 of Newlove and Garner's *Advanced Accounting* (D. C. Heath & Co., Boston, 1951, vol. 1).

2 This distinction is discussed at pp. 514-16 of Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954).

surplus, we believe that to be a misnomer, for the amount involved is neither fully "paid-in" nor "surplus." In this connection, note the following interesting passage from *Montgomery's Auditing* (*op. cit.*, footnote 1, at p. 186) regarding balance-sheet presentation of stock subscription receivables, viz.:

> Receivables arising from subscriptions to capital stock should be stated separately since they are unlike other types of receivables. Some objections have been raised to showing subscriptions receivable as an asset, but, if the debtors are financially responsible and the amounts are apparently collectible, they represent a realizable asset. If, however, they are overdue and doubtful of collection; if there is no intention that they be called; if they are to be collected only out of dividends earned on the stock; or if there is any other contingency with respect to their collection, they may be treated as a deduction from capital stock subscribed in the capital section of the balance sheet.

Objections to showing subscriptions receivable as an *asset* where the subscribers are financially responsible and no other strings are attached are not well-founded, if our understanding as to the legal effect of a true stock subscription is correct, i.e., as with a completed sale, the corporation has a valid legal claim for the full purchase price. On the other hand, we understand that where a contract to purchase stock is involved, upon refusal of the purchaser to accept and pay for the stock certificate, the corporation is relegated to damages, *if any*, for breach of contract. Based on these differences as to legal effect, it seems to us a strong case can be made out for deducting an installment contract receivable in the capital section of the balance sheet, i.e., if the company follows a procedure of recording the full balance remaining to be paid on the contract as a receivable and the full contract amount as paid-in surplus, as in the case in question (rather than merely recording actual installments when and as paid in). Accordingly, one presentation we would deem acceptable in your client's case would be reflected in the capital section of the balance sheet just above capital stock outstanding, as follows:

Contracts for installment sale of stock	xxxx	
Stock sales contracts receivable	xxx	
Capital paid in on installment sales of stock		xx

INQUIRY: **401**

Inquiry **402**

A. May stock covered by fully-paid subscription be shown as outstanding, although certificates not yet issued?
B. Reference re accounting for costs of financing and incorporating

"I would appreciate your opinion on two questions which concern the accounting for a client of ours. This client is contemplating applying for approval to issue stock under Regulation A.

"First, the corporation has received stock subscriptions from the prospective stockholders, and these stock subscriptions have been paid. The stock certificates have not been issued. My question is: Can the financial statement show capital stock under the stockholders'-equity section as being X number of shares even though the certificates have not been issued as of the date of this statement?

"Also, in regard to this same client, they incurred several months of expenses, i.e., rent, office salaries, and other administrative expenses, prior to going into production. The question here is: Can these expenses be amortized over the productive months of the corporation and, if so, what is to determine the period of amortization?"

Our Opinion

Since, in the case described in your letter, it appears that "present subscriptions" (as distinguished from "contracts to purchase stock") are involved, which subscriptions moreover are fully-paid, we believe there is a sound basis for reflecting the capital stock in question in the equity section of the financial statement.

Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954, at pp. 515 and 531-2) elucidates the legal effects of a stock subscription, viz.: that subscribers acquire the rights and assume the liabilities of stockholders upon corporate acceptance of the subscriptions. One can be the true owner of a corporate capital share even though he does not hold, for one reason or another, a certificate evidencing same. A certificate of stock is the physical representation of ownership, being a written certification by officers of a corporation of the ownership of a certain number of shares in a corporation.

We believe you should key a footnote to the item "Capital Stock" in the balance sheet (or parenthetically indicate after such caption) that such capital stock "represents X number of fully-paid shares, certificates for which are to be issued" (on or about date, if known).

Regarding the second question which you ask, it seems to us the administrative expenses prior to commencing production would be associated or involved with one or all of three initial functions common to all new manufacturing corporations: namely, the securing of capital, organizing and incorporating, and starting up or setting up production. If there is no basis for direct assignment of the expenditures in question, we believe it proper to allocate such expenditures on some reasonable basis to Costs of Securing Capital, Organization and Incorporation Costs, and Production Start-Up (or Pre-production) Costs, accounts. Accumulated Pre-production Costs should be amortized rapidly once operations commence, charged against the first one, two, or three years' operations. As for treatment of Financing, and Organization, costs, one of the best discussions of this subject which we have seen in the literature is Newlove and Garner's *Advanced Accounting* (D. C. Heath & Co., Boston, 1951, vol. 1), at pp. 65-9.

STOCK REGISTRATION COSTS

Inquiry 403

Costs incurred in connection with discontinued equity financing program, pending reregistration

"In connection with an audit on which we are presently engaged, a problem has arisen as to the proper accounting treatment of costs applicable to an equity financing program which did not materialize. A complete statement of facts in connection therewith follows, and we request your advice in the handling of said items.

STATEMENT OF FACTS

"In May of 1960, company filed a registration statement (Form S-1) under the *Securities Act of 1933* covering the registration of 200,000 shares of its common stock being offered for public sale. In October, 1960, before the registration became effective, company, with the consent of the Securities and Exchange Commission, withdrew said registration statement with the intent that it would refile as soon as practical thereafter using different financial statement dates. However, in connection with the original filing, company incurred expenses of approximately $30,000 for legal, accounting fees, printing costs, etc.

"We were first engaged by company in October, 1960, and are in the process of auditing company's financial statements for the periods ended October 31, 1960, which will be included in a new registration statement (S-1) to be filed by company before January 31, 1961. It is contemplated that this registration statement will cover the same number and class of equity securities as the previous filing. During the periods under review, company charged its capital surplus account with the $30,000 of expenses applicable to the May, 1960, registration. Although we concur in this treatment, we have been unable to find corroborating support for such treatment in any of the accounting manuals and are concerned that the Securities and Exchange Commission may contend that these costs be charged to income rather than capital surplus. This may seriously affect the company's earnings since it is quite probable that these items would not be deductible for income tax purposes and, consequently, company's earnings would be reduced by the full amount of said costs."

Our Opinion

None of the Institute's official bulletins deal with the precise situation with which you are confronted. However, the following paragraph from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at pp. 384-5) indicates what we believe to be the more generally accepted practice in accounting for expenses of stock issues:

> Expenses of Stock Issues. – Underwriting discounts, professional fees and related expenses are properly considered a reduction of the proceeds of a stock issue before determining the amount to be capitalized. These expenses include commissions to selling agents; attorneys', engineers', or accountants' fees; printing costs; SEC filing fees; and other expenses clearly and directly attributable to realization of proceeds of the shares issued. If the offering price

> is at least par value but expenses of issue bring the net proceeds below par or stated value, the stock should be shown at par and the difference charged first to any available paid-in surplus on issues no longer outstanding, and the balance against earned surplus.

We believe both the expenses incurred in connection with the original filing and those incurred or to be incurred in the subsequent filing before January 31, 1961, should be accorded the same ultimate accounting treatment. Pending actual issuance of the shares covered by the registration, apparently it will be necessary to carry such expenses as a suspense item, shown as an unallocated deduction from the sum total of capital elements.[1]

Inquiry 404

Treatment of aborted stock registration costs and acquisition or financing costs

"There follows a statement of facts concerning financing costs incurred by our client. We would appreciate any opinion your department can render to assist us.

STATEMENT OF FACTS

"In September, 1961, Company A, a publicly-held company, filed a registration statement with the SEC covering the proposed offering and sale of additional shares of its common stock, having then a market value of approximately $2,500,000. In November, 1961, prior to the registration having become effective, Company A contracted to acquire all of the net assets and business of Company B. Company B was a privately-held company which was in the throes of going public in its own behalf and had filed its registration statement with

[1] For further discussion of the treatment of stock issue or financing expenses, see Newlove and Garner's *Advanced Accounting* (D. C. Heath & Co., Boston, 1951, vol. 1) at pp. 65-9, and also p. 21.24 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956). It is of interest to note here that the *New York Business Corporation Law* which became effective September 1, 1963, provides that reasonable expenses of organization or reorganization or reasonable expenses of and compensation for the sale or underwriting of shares may be paid or allowed out of the consideration received for such shares without impairing their fully-paid status.

the SEC in September, 1961. The acquisition was consummated in December, 1961. Company B's registration statement was then withdrawn. In February, 1962, Company A's registration statement (filed in September, 1961) was amended to include all facts incident to the acquisition and the financial statements and the summary of earnings contained therein were revised to eliminate those of Company A and to substitute, in lieu thereof, combined financial statements of Company A and B as a pooling of interests. Costs incurred by Company B in connection with its September, 1961, registration statement and costs incurred by Company A in connection with the original registration statement filed in September, 1961, were deferred on the combined balance sheet as at December 31, 1961, with a footnote that such costs would be charged against the capital surplus that would result from the sale of the additional shares of common stock. These costs approximated $54,000 and $70,000 respectively. A note to the December 31, 1961, financial statements also indicated that all costs in connection with the acquisition of the net assets of Company B (which costs consisted primarily of accounting fees, legal fees and printing expenses in connection with the solicitation of proxies and the preparation of contracts) would be charged to retained earnings.

"In March, 1962, because of the general softness in the selling price of Company A's stock and a general weakness in business conditions affecting electronics companies in the semiconductor field as a whole, the underwriters and Company A mutually decided to abandon the proposed sale of additional equity securities and the registration statement was withdrawn.

"The contract of acquisition between Companies A and B provided that Company A would file a registration statement with the SEC registering the shares of stock issued in connection with the acquisition of Company B's net assets. Accordingly, in June, 1962, Company A refiled a registration statement which was in effect, practically identical with the registration statement filed in February, 1962, except instead of providing for the public sale of common stock, it provided only for the registration (but not for the sale) of shares issued in connection with the acquisition.

"For accounting purposes, Company A now takes the position that all costs incurred by it and by Company B in connection with all of the aforementioned registration statements (Company B – September, 1961; Company A – September, 1961; February, 1962, amendment; June, 1962) should be charged against retained earnings as additional acquisition costs. These costs approximate $55,000 for Company B and $100,000 for Company A. The combined net worth of both companies totals approximately $7,000,000 and the combined net income for the year 1961 was approximately $700,000.

"We concur in the Company's opinion that the aforementioned costs constitute a proper charge against retained earnings rather than operations, since Company A was contractually committed to register the shares issued to Company B's shareholders, and in so doing would have incurred costs somewhat comparable to the costs in question."

Our Opinion

We agree that the total costs in question should not be charged against current *operations* on the grounds that (1) such costs are both material and extraordinary, (2) are clearly not identifiable with the continuing company's usual or typical business operations, and (3) represent cost expenditures primarily attributable to capital transactions (albeit certain of the contemplated capital transactions, viz., sale of additional equity securities to the public, were abortive). Furthermore, we believe the following statement appearing at p. 396 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) is an authoritative guide relating to disposition of the costs in question, viz.: "Expenditures and write-offs incident to reorganization, recapitalization, merger, or consolidation are charged either against paid-in surplus resulting therefrom or against earned surplus." Although we believe this statement intends to convey the thought that it is optional whether such costs are charged to earned surplus or to paid-in surplus (resulting from merger in this case) since both treatments are found in practice, nevertheless, on the ground that the costs are basically attributable to a "capital transaction," we personally would construe the passage to mean that the costs in question should first be charged to any paid-in surplus arising upon issuance of shares pursuant to the pooling, to the extent thereof, and then any unabsorbed portion of the costs be charged to earned surplus.[1]

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1 Author's afterthought: It appears one might also make a case out here for charging all costs attributable to the aborted registrations for the sale of additional shares to the public (Company A — September, 1961, and Company A — amendment February, 1962) to earned surplus as in effect, a material-extraordinary loss; and for charging all costs directly attributable to the acquisition (Company B — September, 1961, registration subsequently withdrawn due to the acquisition, the accounting and legal fees and printing costs in connection with solicitation of proxies, and preparation of contracts, and the refiled June, 1962, registration statement covering shares issued in connection with the acquisition) to any paid-in surplus arising upon issuance of shares pursuant to the pooling.

TREASURY STOCK, REDEMPTION OF STOCK, ETC.

Inquiry 405

Stock reacquired and held in treasury for purpose of awarding prizes or bonuses to employees

"We have an accounting question on which we would like to have some help.

"Our company intends to keep some shares of common stock available to be occasionally given away to an agent or sales manager as a contest prize, perhaps also to some employees as a bonus.

"One way would be to purchase such shares in the market, after the company management has decided to whom and in what number to give away such shares. The purchase price would be charged to the proper expense account and we could have the certificates issued in the name of the recipients.

"Our management would prefer to have a certain number of shares available at all times for such purposes. It seems to us that stock purchased by the company for this purpose has to be considered as treasury stock, and that this involves specific disadvantages. According to Illinois law, no cash dividend or stock dividend can be paid on treasury stock. As far as cash dividend is concerned, this would result in an odd amount of dividend paid, where in the past we had always round amounts: $.40 cash dividend a share per year on a round number of outstanding shares. The bigger question seems to arise from the exclusion of treasury stock from stock dividend. Our company has paid a stock dividend in each of the past few years and intends to do so in the next few years.

"Let's assume that a stock dividend of one new share would be declared on each 12 shares of our present 1,200,000 shares of outstanding capital stock of $1 par value each. Let's assume further that at the date of record the company owns 50 shares of its own stock as treasury stock. In the past, our stock dividends were always planned to result in an even number of shares after the transaction. The exclusion of the treasury shares from the stock dividend would result in:

Number of outstanding shares before stock dividend	1,199,950
Plus stock dividend 1:12	99,995-5/6
	1,299,945-5/6
Plus treasury stock (unchanged)	50
Total number of shares after stock dividend	1,299,995-5/6

"Not only will we end up with an uneven number of shares and a fraction, but this will be perpetuated throughout all future stock dividends.

"Besides, the treasury shares represent a lower equity in our company than they did before the stock dividend. This may be correct where the treasury stock has been purchased in considerable amounts to be kept out of circulation either for a long period or permanently. It does not seem to fit our situation, where the company wants to retain a few of its own shares, only temporarily, with the explicit purpose of giving them away to some selected agents or employees with specific merits.

"Our question is:

"Are such temporary holdings of relatively few shares for giveaway purposes to be considered as treasury stock, or is there a way to handle them differently?

"If you think that they have to be treated as treasury stock, we would like to know how to show treasury stock properly in the annual statement."

Our Opinion

We note that section 2(j) of the *Illinois Business Corporation Act* (as amended by L.1957) defines treasury shares as follows:

> "Treasury shares" means shares of a corporation which have been issued, have been subsequently acquired by and belong to the corporation, and have not, either by reason of the acquisition or thereafter, been cancelled or restored to the status of authorized but unissued shares. Treasury shares shall be deemed to be "issued" shares but not "outstanding" shares. . . .

On the basis of the foregoing, it appears that an acquisition by a company of its own stock for contest or bonus purposes falls within the purview of this section. Thus the stock so acquired is properly classified on the balance sheet as "Treasury Shares," and is not deemed to be "outstanding shares." We note also that section 26 of the *Act* provides that dividends in cash, property, or its own shares can only be paid on outstanding shares.[1]

[1] Regarding the financial presentation of treasury stock, one of the best discussions which we have seen is at pp. 388-90 and 426-7 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957). Other excellent discussions may be found in the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) at pp. 21.31-5, in G. S. Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957) at pp. 141-5, and in the item, "Balance Sheet Presentation of Treasury Shares," which appeared in Carman G. Blough's column at pp. 74-5 of the April, 1963 issue of *The Journal of Accountancy.*

INQUIRY: 405

In connection with the issuance of stock dividends, if, starting with an even number of outstanding shares, your objective is to come out with a specified total "even number of shares after the transaction," as seems to be indicated in your letter, we believe this objective can be accomplished by subtracting the former from the latter number and expressing the difference as a percentage of the former number. This percentage would be the stock dividend rate. Of course, if cash were paid to individual stockholders in lieu of fractional shares, the end result envisaged by the foregoing procedure could not be achieved.

As a possible solution to the problem created by the acquisition and reissuance of treasury stock, we suggest you give consideration to the feasibility and legality of earmarking authorized but unissued stock for the purpose of rewarding selected agents or employees with specific merits. Whether such stock would be deemed fully-paid, non-assessable and issued for adequate consideration (e.g., as an adjustment of compensation for "labor or services actually performed") is, it seems to us, a legal question upon which the advice of counsel should be sought. Also, should the above procedure be feasible except for the fact that all of the authorized stock has already been issued, you may wish to consider the possibility of taking appropriate legal steps to amend the charter so as to increase the amount of authorized but unissued stock which might then be availed of for these special purposes. Section 24 of the *Illinois Business Corporation Act* seems relevant in this connection, viz.:

> Unless otherwise provided by its articles of incorporation, any corporation may issue and sell its shares to the employees or to the employees of any subsidiary corporation, without first offering the same to its shareholders, for such consideration and upon such terms and conditions as shall be approved by the holders of two-thirds of its shares entitled to vote with respect thereto or by its board of directors pursuant to like approval of the shareholders.

Inquiry **406**

Reacquisition of its own shares and purchase of encumbered real estate by corporation undertaking to pay life annuity to stockholder

"I am requesting your assistance in aiding me to resolve an accounting problem for which there appears to be a dearth of accounting literature. In essence, the problem involves a stock-redemption private annuity plan.

"The facts are these:

"An 85 per cent stockholder of a small building-hardware supply company, wishing to divest herself of such stock, has transferred to the corporation *for cancellation* all her shares of stock; and *simultaneously* has transferred to the corporation real property owned personally by her (and previously rented to such corporation), subject to existing mortgages of $25,000, in exchange for the corporation's promise to pay her an annuity of $560 per month for life. Immediately prior to the transfer, the real property was appraised at $75,000. The transaction leaves the remaining two stockholders, related in no way to the transferor, in control of the corporation. Were a comparable annuity to be purchased from an insurance company, the premium would amount to $140,000 for a female aged forty-eight who has, according to the CSO mortality tables now in use, a life expectancy of 22.88 years.

"Immediately prior to the annuitant's transfer, the net assets of the corporation amounted to $50,500. By capitalizing profits in excess of a rate of return agreed upon by the annuitant and remaining stockholders, my computation values the goodwill at $40,000. This value, of course, is not to be set up on the books. Just immediately after the transfer of stock and real property, it would appear that the corporation may be valued at the following:

Net Assets	$ 50,500
Goodwill	40,000
Real Property	75,000
	$165,500
Less: Mortgages Assumed	25,000
	$140,500

"Tentatively, I have the following journal entry in mind:

	Dr.	*Cr.*
Common Stock	$15,700	
Real Property	75,000	
Mortgages Payable		$25,000
Capital Surplus		65,700

"Assuming the entry above is valid in this situation, annuity payments to the annuitant would be charged against Capital Surplus. If and when capital surplus becomes extinguished, further charges would go to Retained Income. This treatment, of course, would be followed by a somewhat lengthy balance-sheet footnote setting forth the highlights of the agreement together with an explanation of how the annuity payments are being handled. Charging the annuity payments to Capital Surplus may appear to be peculiar, but I am taking the position, perhaps mistakenly, that since capital surplus arose from the annuity transaction as a whole, it should bear the brunt of these charges since these charges are neither expenses nor losses.

"In your opinion, would handling the problem in the fashion presented subject me to criticism? If so, what alternative solutions would you suggest?"

Our Opinion

In our opinion, the journal entry and proposed treatment which you set forth in your letter is insupportable from the standpoint of generally accepted accounting principles. We do not believe it is acceptable for the corporation immediately to recognize or *anticipate* a gain or capital increment upon redemption of the common stock, acquisition of the real property, and effective assumption of the mortgage obligations. The total amount of consideration to be paid by the corporation to the annuitant is not only prospective but also *contingent*. Your proposed treatment, it appears, would recognize a gain or increment on a purchase contract which is wholly executory on the corporate purchaser's part.

One possible treatment which might have some support among accountants and which we seriously considered, but then discarded, is the following:

Dr. Real Property	$75,000	
Common Stock	15,700	
Deficit–Loss upon Retirement of Stock	74,300	
Cr. Mortgages Payable		$ 25,000
Annuities Payable		140,000*

* Without actual computation, we are assuming, for purposes of illustration, that this figure represents the present value of the series of annuity payments to be made during the period of the annuitant's life expectancy.

Obviously, the foregoing treatment would result in an excess of liabilities over assets and a deficit greatly in excess of capitalization (see Carman G. Blough's column in August, 1954 issue of *The Journal of Accountancy,* item entitled "Financial Presentation When Deficit Exceeds Capitalization"). The general acceptability of setting up a liability on the above basis depends upon whether such liability may properly be deemed an *actual* or "true" liability or whether it is more properly to be deemed *contingent.* To view it as an actual liability, one would have to accept the *actuarial* premises on which its computation is based. Personally, we are inclined to look upon the corporation's liability as contingent. An actuarial estimate may be made, but whether this gives us a "close estimation," i.e., an approximation, is uncertain and can only be proved by events. What the eventual cost of the real property and the retired stock to the corporation will be is a matter of conjecture, contingent on how long the annuitant lives. We might also mention that the "deficit" or "loss" recognized perforce in the foregoing entry is wholly anticipatory, is not presently realized and may never be realized in any practical sense.

Since we have a novel problem, we have chosen a rather novel approach; however, one which we believe is supportable on principle. Accordingly, we would be inclined to set the transaction up initially in terms of *the only definite liability effectively and presently assumed,* viz.:

Dr. Common Stock	$15,700	
Real Property	9,300	
Cr. Mortgages Payable		$25,000

Thereafter, each month during the course of the annuitant's natural life, the corporation should accrue a $560 Liability for Annuity Payment and allocate the correlative debit(s) to the Real Property and Surplus accounts in the ratios of the values originally assigned to the real property and the common stock in the course of the parties' negotiations. What this method boils down to, of course, is piecemeal recognition of the installments payable when, as, and if they accrue, with concurrent recognition of the additional cost attributable to the stock and real property acquired. Thus, if $140,000 was estimated as the present value of the annuities payable to the retiring stockholder over her life expectancy and $50,000 ($75,000 appraised value less mortgage) was accepted as representing the net fair value of the real property, then *debit*

$$\frac{50{,}000}{140{,}000} \times \$560 \text{ to the Real Property account}$$

and

$$\frac{90{,}000}{140{,}000} \times \$560 \text{ to the Surplus account}$$

monthly.

From a financial reporting standpoint, we believe it desirable to disclose, in a footnote to the statements, the nature and principal terms of the corporation's contract with the annuitant, the appraised value of the real property at the time of negotiating the agreement, and the corporation's estimated total contingent liability for annuity payments based on the annuitant's life expectancy at the end of the fiscal year in question.

Inquiry **407**

Reacquisition of its own shares by corporation undertaking to pay life annuity to stockholder

"I am interested in some material on private annuity plans both as to their treatment for bookkeeping purposes and also for income tax purposes. I have in mind a situation where a closely-held corporation buys out one of the major stockholders by giving him a life annuity. I would like to know how the stock recovered is treated on the company books. I would like to know if it is entered as treasury stock and the monthly payments charged against this account or whether it is capitalized. I would also like to know what the Federal income tax treatment of this type of situation is."

Our Opinion

Your problem has actuarial and legal as well as accounting aspects. In our opinion, if not otherwise retired or restored to the status of authorized but unissued shares, one possible approach might be to set up the stock in question as Treasury Stock at the present value of the series of annuity payments prospectively to be made over the life expectancy of the annuitant. A correlative credit in the same amount might be made to a liability account which could be designated "Annuities Payable — Present Discounted Value."

A possible alternative entry would be to debit Treasury Stock with the present value, credit Gross Annuities Payable with the sum of the payments which might have to be made over the period of life expectancy, and debit Deferred Interest Expense with the difference between the present value and gross amount contingently payable. If the latter entry were made, a detailed balance-sheet presentation might be:

Gross Annuities Payable	xx	
Less: Deferred Interest Expense	x	
Annuities Payable — Present Discounted Value .	xx	
Less: Portion Payable within Year*	x	
Non-Current Portion of Annuities Payable — Present Discounted Value		xx

* This would be reflected within current liability section of B/S.

It probably goes without saying that if the Annuities Payable account is set up gross, the Deferred Interest Expense account would be subject to periodic amortization. If the Annuities Payable account is set up net, i.e., at present discounted value, the difference between the gross payment made and the net amount properly chargeable to the liability account in any period should be reflected as interest expense.

If the annuitant died prior to termination of the life-expectancy period, any balance in the liability account would be transferred out for credit to the Treasury Stock account.

In the foregoing we have confined ourselves to accounting aspects on the premise that a binding and valid *present purchase* of the stock has been made with the privilege of making deferred payment therefor in the form of annuities payable. However, we should express a definite caveat to the effect that you should seek legal counsel and opinion on the validity of this contract from the standpoint of any restrictions contained in applicable statutes of the state of incorporation respecting the purchase by a corporation of its own shares. It is quite possible in a situation of this kind that the purchasing corporation might at some future time find itself with an exhausted earned surplus, and thereupon, because of corporate statutory requirements, be forced to default in any further annuity payments to forestall insolvency or impairment of its stated capital. Property rights in the treasury stock might then be open to question.

The approaches described in the first two paragraphs of this reply, it seems to us, are also open to serious question on the ground of basic accounting principle, viz.: Treatment of the transaction as a present purchase of the stock rather than as a long-term commitment or executory contract-to-purchase the stock, might be a much more tolerable view if the corporation acquiring its own stock had sought to bind itself to make a definite number of annuity payments (i.e., a "number of payments certain"). The language "sought to bind itself" has reference to the above-mentioned statutory restrictions. However, the agreement being what it is, immediate reflection of total payments based on life expectancy raises the question whether the corporation is reflecting a contingent rather than actual liability in the statements proper.

In view of further considerations such as these, you may find that the procedure mentioned briefly in your letter (monthly payments charged to treasury stock), is the more practical accounting approach. For example, you might well resort to footnote disclosure of the obligation undertaken by the corporation, referring to the amount of the estimated actuarial liability as being contingent in nature due to the fact that although death of the annuitant is a certainty, nevertheless the period of life expectancy is not determinable with certainty. With this approach the annuities would be accrued periodically as they became due and payable, and periodic charges therefor could be made to an account to be reflected in the equity section of the balance sheet as "Annuity Installments Paid or Accrued on Treasury Stock Purchase Contract."

As a matter of Institute policy, we do not undertake to give opinions on the tax aspects of questions submitted.

Inquiry 408

Installment purchase of treasury stock for total contract price in excess of total net assets

"I wonder if you could assist me in determining the proper balance-sheet presentation of the following treasury stock purchase transaction. Assume the following facts:

"1. Corporation with fiscal year ending March 31, 1960, has outstanding common stock in the amount of $35,000.

"2. Retained earnings 3/31/59 were $48,000; at 3/31/60, they were $55,000.

"3. On February 1, 1960, corporation contracted to purchase 50 per cent of its outstanding stock for $125,000, payable as follows: $25,000 down, $300 per week on balance, interest included. At March 31, 1960, payments on principal totaling $27,655 had been made.

"4. The stock itself is sole security for the liability. It shall remain in escrow until date of final payment, at which time, title will also pass. Should default occur, stock would revert to seller, and payments already made by corporation would be considered forfeited."

Our Opinion

In our opinion, the payments on total contract price totaling $27,655 at March 31, 1960, could be reflected in the balance sheet as a deduction from the sum total of capital stock and retained earnings and be given a designation such as "Installment Payments on Treasury Stock Purchase Contract." We believe the rule of informative disclosure would require that a succinct statement regarding the nature and terms of the stock purchase contract be set forth in a footnote to the financial statement. It seems to us the language of the first sentence under item 3 in your letter conjoined with the language of the first two sentences under item 4 thereof and a further statement that earned surplus is restricted in the minimum of $27,655, would accomplish an appropriate disclosure.

The rationale underlying the above-recommended treatment is based on the assumption that the transaction in question involves an "executory contract to purchase" shares which will ripen into a "purchase" of the shares only when conditions precedent respecting payment have been met and the escrow holder transfers the certificates representing the shares to the corporation. An accounting presentation whereby treasury shares would be reflected as such and carried at the total contract price and the unpaid balance of future installments payable shown as a liability might prove embarrassing from the standpoint of capital impairment. We believe careful perusal of the relevant sections of the *California General Corporation Law* governing "acquisition by a corporation of its own shares" will bear this out. (We are assuming, of course, that a California corporation is involved.) Query what the legal status of this contract is if the point is reached where cumulative installment payments exceed earned surplus.

Inquiry 409

Negative capital arising from redemption of 50 per cent interest of one stockholder

"I have come across a question on which I would like to have your opinion.

"FACTS: A fairly new corporation is capitalized at $100,000, with two equal stockholders. After it has a nominal amount of retained earnings, the corporation redeems the entire 50 per cent interest of one stockholder for $125,000. This is due to the fact that the two stockholders (not related) reached an arms-length agreement on the price. However, the fair market value of the stock acquired appears to be quite a bit less than its cost to the corporation at the time of its redemption.

"From an accounting theory point of view acquisition of shares held as treasury stock are usually carried at cost and deducted from paid-in capital and retained earnings. In this case, such a treatment would result in a negative capital section.

"QUESTIONS: Is it possible to allocate part of the purchase price to goodwill? Under what circumstances, if any, is this ever permissible? Is there any other recommended treatment for this type of transaction?"

Our Opinion

In our opinion, the transaction you describe is a capital transaction, and it would be contrary to generally accepted accounting principles to allocate any part of the purchase price of the redeemed stock to goodwill. What appears to be involved here is an illegal transfer of corporate property to an officer or stockholder which, depending on the circumstances, may or may not prejudice the rights of creditors. Many state corporation statutes, of course, specify minimum capitalization requirements; many such statutes also circumscribe and limit a corporation's right to reacquire its own shares. For example, section 5 of the *Model Business Corporation Act* (sponsored by the American Law Institute and American Bar Association) states that:

> A corporation shall have the right to purchase . . . its own shares, but purchases of its own shares, . . . shall be made only to the extent of earned surplus available therefor, and, if the articles of incorporation so permit . . . to the extent of capital surplus available therefor, and subject to the following additional limitations:
> (a) No purchase of its own shares shall be made at a time when the corporation is insolvent or when such purchase would render the corporation insolvent.

Section 60 of the *Model Act* states that:

> No redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such redemption or purchase would render it insolvent. . . .

The following paragraph from Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954, at p. 552) may also be of interest:

> Right of corporation to buy its own stock. Some states (Washington, Missouri and California, for example) have held that a corporation cannot purchase its own shares of stock either to retire or to reissue them. The better rule, however, is that a corporation may acquire and hold its own stock, provided:
> (a) The transaction is fair and made in good faith.
> (b) The transaction is free from fraud.
> (c) The rights of creditors and other stockholders will not be prejudiced by the purchase.
> (d) The purchase is made out of an existing surplus.

(e) The purchase will not cause the corporation to lose its surplus nor to become insolvent.
(f) The corporation is not in the process of dissolution.

Regarding financial presentation in a case such as you describe, you may find helpful an item entitled "Financial Presentation When Deficit Exceeds Capitalization," which appeared in Carman G. Blough's column in the August, 1954 issue of *The Journal of Accountancy*. See also the exchange of correspondence *directly following* herein.

Inquiry 410

Deficit arising from redemption of officer's stock

"We would appreciate your opinion on the following:

"Corporation (Mining Engineers) purchased stock of retiring officer-stockholder, valuation based on five-year earnings formula.

Original cost of stockholder's stock (5%)	$ 24
Total capital stock issued (120 shares)	120
Corporation surplus at end of year	41,000
Price paid by corporation to retiring stockholder for his share (5%)	44,000

"We would appreciate your advising us what entries are to be made on the books of the corporation."

Our Opinion

We believe the entries to be made to record the acquisition by the corporation of its own stock would be as follows:

Dr. Treasury Stock	$44,000	
Cr. Cash		$44,000

Upon subsequent retirement of the stock, we would suggest the following entries:

Dr. Capital Stock Issued	$ 6	
Surplus	43,994	
Cr. Treasury Stock		$44,000

However, we do not believe it would be proper for financial presentation purposes simply to show a debit balance in corporation surplus account in the net worth section. (Incidentally, we are unable to determine from your letter whether this corporation surplus account includes both paid-in and earned surplus.)

Assuming for purposes of illustration that your client corporation has total assets of $50,000 and total liabilities exclusive of net worth accounts of $52,880, we would be inclined to suggest the following manner of presentation which is patterned after the item entitled "Financial Presentation When Deficit Exceeds Capitalization" (in Carman G. Blough's column in the August, 1954 issue of *The Journal of Accountancy* at pp. 203-05):

THE MINING ENGINEERS CORPORATION

Statement of Assets, Liabilities and Deficit Arising from Redemption of Officer's Stock as of December 31, 1961

This is what we owe: (Liabilities in detail)		xxxxxx
Total Liabilities		$52,880
This is what we have: (Assets in detail)		50,000
Excess of Liabilities over Assets		$ 2,880
Derived from:		
Cost of Stock Redeemed and Retired		$44,000
Less: Surplus Eliminated Thereby	$41,000	
Capital Stock Retired	6	
Capital Stock Outstanding and Impaired	114	41,120
Deficiency in Assets Available to Satisfy Obligations to Creditors		$ 2,880

It is our understanding that, in New York, a corporation's purchases of its own stock are limited to the amount of its earned surplus, and we believe this holds true in many other states.[1]

Inquiry **411**

Capital impairment due to purchase of treasury stock and payment of dividends from restricted surplus

"I would be very grateful if you could help me with the balance-sheet presentation of capital stock in situations where small corporations redeem a portion of the stock outstanding and, in some instances, later sell stock to other stockholders.

"As a specific illustration, I am enclosing two balance sheets for one of my clients. The December 31, 1957, balance sheet was prepared by another CPA, and the December 31, 1958, balance sheet was prepared by myself. Neither is an audited statement.

"This corporation was organized in November, 1954, with authorized capital stock of $100,000. Stock in the amount of $94,400 was issued to about forty stockholders for cash. In 1955, the corporation acquired for cash and at par value $4,000 of its stock, and in 1957, it acquired $5,000 of its stock in the same manner. These acquisitions terminated the respective stockholders' interests and the stock certificates were physically voided.

"In 1959, the corporation has issued $5,000 of capital stock to its president at par value, partly for cash and the balance for notes. This transaction, like the acquisitions, has been handled with a minimum of formality and without the aid of legal counsel.

"I would appreciate your suggestions and comments on the state-

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1 In this connection, see pages 512 and 528 in Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954). The *New York Business Corporation Law* which became effective on September 1, 1963 (i.e., subsequent to this exchange of correspondence) provides in essence that a corporation may never purchase or redeem its shares if it is insolvent or would thereby be made insolvent (sec. 513(a), (b), and (c)); otherwise such purchase or redemption may be made out of surplus at any time (sec. 513 (a)). "Insolvency" means inability to pay debts as they become due in the usual course of business (sec. 102(a)(8)). "Surplus" is defined as the excess of net assets over stated capital (sec. 102(a)(13)). The purchase or redemption of (redeemable) shares may not reduce the net assets below the stated capital remaining after giving effect to the cancellation of such shares (sec. 513(c)).

ment presentation in this case and would specifically like your comments on the footnote to the December 31, 1957, balance sheet."

Pertinent Portion of December 31, 1957, Balance Sheet:

STOCKHOLDERS' INVESTMENT:

Capital stock – par value $25.00 a share:				
Authorized	4,000 shares			
Issued	3,776 shares			
Less in treasury	360 shares			
Outstanding	3,416 shares		$85,400.00	
Earnings retained in the business – Note A:				
Balance at January 1, 1957		$ 3,244.41		
Net earnings for the year		6,914.76		
		$10,159.17		
Less cash dividends paid		5,424.00	4,735.17	$90,135.17

Note A – Earnings retained in the business are restricted in the amount of $9,000.00 representing the par value of capital stock held in the treasury.

Pertinent Portion of December 31, 1958, Balance Sheet:

Capital:			
Capital stock, $25 par:			
Authorized	4,000 shares		
Issued	3,416 shares	$85,400.00	
Retained earnings, as annexed		4,147.84	
			$89,547.84

Our Opinion

The physical voiding of stock certificates representing reacquired shares does not by itself effect a formal retirement of such shares or formal restoration of such shares to the status of authorized but unissued shares. Cancellation of stock certificates and cancellation of shares, i.e., retirement thereof by charter amendment, are two different things. We understand that it is general practice to cancel or void the certificates as such whenever they are surrendered to, or acquired by, a corporation for whatever purpose; then, without appropriate charter proceedings, either to retire the shares or to restore them to an authorized but unissued status, such shares represented by the reacquired certificates have a treasury stock status.

Accordingly, in the case in question, unless there is some evidence in the corporate minutes or elsewhere that the board has taken specific formal action to retire the shares or give them an authorized but unissued status, the shares are properly deemed to be treasury shares.

If, based on the source from which your inquiry comes, we can further assume that the client in question is a Michigan corporation, then, in our opinion, both your presentation and that of the other CPA are clearly erroneous. The footnote used by the other CPA is a mitigating factor in his favor. It should also be stressed that the fact that the statements in question are "unaudited" and the CPA intends to disclaim an opinion does not relieve the CPA of all further responsibility for fair presentation.

For your information, we note that section 10h of the *Michigan General Corporation Act* reads as follows:

> . . . any corporation which purchases its own capital stock shall keep its books and records and prepare its annual report to the state *and its annual report to its shareholders* in such manner as to indicate clearly the cumulative effect of such purchases, either by showing the *cost* of such respective purchases as a deduction from surplus or by classifying its surplus accounts in such manner as to show the *amount of surplus applied to such purchases* and *which therefore shall not be available for dividends of any kind* or for additional purchase of its own stock or for any other purpose. . . . (*emphasis added*)

In view of the foregoing, it appears that the proper presentation would be to reflect the 3,776 *issued* shares at $94,400, then to show short the earned surplus balance at the end of the year with the $9,000 cost of the treasury stock deducted therefrom, with the debit difference between the latter two figures extended to the margin described for what it is, namely, *capital impairment due to payment of dividends from restricted earned surplus.*

Quite apart from the requirement of the Michigan statute that the cost of treasury stock be shown as a *deduction* from "surplus" or as an *application* thereof, the following passage from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, pp. 426-7) is quite pertinent on the question of the "constructive" retirement of treasury stock which in essence is what the two presentations in your letter reflect, viz.:

> Formerly it was not uncommon to show treasury stock "as if" it were retired; the par or stated amount of treasury stock was deducted from capital stock, and the appropriate surplus accounts were adjusted for the difference between cost and par or stated value. In most states, this procedure reflected the situation as it would have been if the legal steps necessary for retirement of treasury stock had actually been taken. Serious objections to this method are that it implies a future retirement which may not take place, and does not indicate the possible effect on surplus of the restrictions arising from acquisition of treasury stock; therefore, it is not now considered the best practice.

Incidentally, many state statutes provide that securities may not be issued except for "labor done, or money or property actually received." Shares issued in violation of such a provision are at least voidable and, depending on the state, may be void in the hands of the original holder. According to Israels' and Gorman's *Corporate Practice* (Practising Law Institute, N.Y., 1962, at p. 39): "The courts do not agree as to the acceptability of promissory notes as consideration for the issuance of shares and some statutes specifically prohibit their acceptance." Determination should be made whether the $5,000 of capital stock issued to the president, partly for cash and the balance for notes, is affected by any such provision.

Inquiry 412

Stock purchase agreement between corporation and estate of decedent stockholder

"I have recently been confronted with a problem relative to the proper presentation of an item on the balance sheet. I am submitting the following facts and would appreciate your comments as to the correct presentation.

"Corporation X has 1,000 shares of $100 par value common stock authorized. 456 shares are unissued, leaving a balance of 544 shares issued and outstanding at a value of $54,400.

"Several years ago the company acquired 84 shares of the outstanding stock for cash in the amount of $8,920. This stock is presently being held as treasury stock.

"During the current year one of the major stockholders, holding 220 shares, passed away, and the corporation entered into a stock purchase agreement whereby they would buy the 220 shares. An appraisal was made to determine the value of the shares and the cost was established at $197.89 per share.

"According to the stock purchase agreement, title to the stock was not to be transferred to the corporation until after complete payment was received. Failure on the part of the corporation to abide by the terms would result in cancellation of the agreement and all payments made on the stock would be retained by the seller as liquidated damages.

"I have two questions relative to the above facts. In your opinion, what would be the proper presentation of the treasury stock in the balance sheet; and second, in view of the fact that title to the stock does not pass until the stock is completely paid for, should this contract be recorded as a liability or recorded as a footnote in the equity section of the balance sheet?"

Our Opinion

Your letter does not indicate the amount of earned surplus, if any, of the client in question, and whether this stock purchase arrangement has the effect of impairing stated capital, in violation of any statutory provision in the state of incorporation placing restrictions upon a corporation's acquisition of its own stock. If payments made, or to be made, under the contract exceed, or will exceed, your client's surplus, we believe you should obtain the opinion of competent counsel as to the present legal status of this stock purchase contract, i.e., whether it is void, voidable, or valid.

In your particular case, we would be inclined to favor "Presentation No. 2" mentioned in the correspondence *directly following this reply*. However, rather than setting up a Treasury Stock Redemption Fund, we suggest that the cumulative installments paid be shown in an account such as "Installment Payments Made on Stock Purchase Contract," and reflected as a separate deduction from earned surplus, thereby directly indicating the extent to which the latter account balance is restricted.

We believe the rule of informative disclosure would also require a footnote setting forth the salient facts relating to the corporation's undertaking to purchase its own stock. Presumably, if there is any infirmity in the legal status of the stock purchase contract, necessary explanation should be made. In the event the stock purchase contract would be deemed void, consideration may have to be given to the question whether cumulative payments made to date should more properly be classified as a receivable since, then, the liquidated damages clause would fall with the contract.

Initial Inquiry **413**

Installment purchase by corporation of major stockholder's shares, secured by mortgage and escrow arrangement

"In the course of performing an annual certified audit, we have encountered a very unusual accounting problem. Would you give us your views as to precisely how the facts should be reported on the balance sheet? Here are the facts:

"On September 1, 1960, a closed corporation, with three stockholders, signed an agreement with one stockholder in order to acquire his one-third interest. The following facts are quoted directly from the sales agreement:

(a) Stockholder hereby sells to the Corporation all of his stockholdings in said Corporation, being 1/3 of all issued and outstanding common stock.
(b) The price to be paid by the Corporation shall be the sum of $45,000 which shall be paid in 120 successive monthly installments of $375.
(c) The Corporation shall give to the stockholder as collateral security for the performance of the purchaser's covenants in this agreement, a mortgage which shall be a general lien on all properties of the Corporation. This mortgage shall be subordinate to the first and second mortgages presently existing.
(d) Default – Should the Corporation default in the payment of

any monthly installment due on the purchase price of the stock, the stockholder at his election may declare the entire remaining balance of the purchase price then due and payable forthwith, and the stockholder may resort to the mortgage given as collateral security and may foreclose and sell the real estate in order to satisfy and pay in full the then remaining unpaid balance of the purchase price herein fixed.

(e) Upon delivery of the Corporation's mortgage to the stockholder, the stockholder will forthwith endorse all certificates to the Corporation in blank with a general stock power attached, and deliver the same to an independent escrow agent, who shall hold said certificates and shares of stock in escrow pending performance by the Corporation of its covenants under this agreement; provided, however, that annually and the first day of September of each year if all installments have been made in full during the preceding year, the escrow agent may surrender the certificates then held by him hereunder and cause 1/10 of the total number of shares to be issued to the Corporation and recorded on its books in its name, but the escrow agent shall continue to hold in escrow from year to year the remaining certificates, the property of the stockholder, until final payment shall have been made under this agreement, whereupon the escrow agent shall deliver all remaining stock held by them to the Corporation.

In the event of default by the Corporation, the escrow agent shall redeliver to the stockholder all shares of stock then remaining in their hands, free and discharged of any restrictions imposed by this contract.

(f) So long as this agreement shall remain in effect and unperformed as to any installment payment due hereunder, the stockholder shall have the right to vote shares of common stock of the Corporation held by him and undelivered.

(g) The stockholder shall forfeit the right to any dividends.

"Assuming the above facts, in your opinion, would either one of the following presentations be acceptable for presentation on the certified balance sheet?

Presentation No. 1

1. Treasury Stock (Cost)	$45,000	
Note Payable – Long Term		$40,500
Note Payable – Current		4,500
To record the cost of Treasury Stock at acquisition date 9/1/60.		
2. Note Payable – Long Term	$ 1,125	
Cash		$ 1,125

To apply three monthly payments of \$375 each against the note, assuming that the balance will be presented at 12/31/60.

3. Restrict the Retained Earnings in the amount of the Treasury Stock.
4. Note on the balance sheet beside the Note Payable that it is secured by the Land and Buildings, and that the sale of the stock by the Corporation is restricted since it is held by the escrow agent.

Presentation No. 2

1. Treasury Stock Redemption Fund (Other Asset)	\$ 1,125	
Cash		\$ 1,125
To record cash payments made to stockholder as a deposit against the purchase of common stock.		
2. Footnote the balance sheet with the details of the entire transaction. When the escrow agent transfers the stock to the Corporation after 1 year's installments have been paid, the following entry could be recorded:		
Treasury Stock	\$ 4,500	
Treasury Stock Redemption Fund		\$ 4,500
To record stock transferred to the Corporation by the escrow agent."		

Our Initial Opinion

In discussing "Margin and Instalment Purchases" in the chapter on "Investments," the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, at p. 13.4) states the following:

> Instalments paid on stock or bond subscriptions may be charged to a special investment account until the purchase is completed or, as an alternative, the total contract price may be set up, an appropriate liability account being credited with the balance unpaid. On the whole the second treatment is preferable. Finney and Miller (Principles of Accounting, Intermediate) state:
>
> "If securities are purchased through a broker on margin account, the books and the balance sheet should reflect as an asset the full

> cost of the securities and not merely the margin deposit, and the unpaid balance should be shown as a liability. Similarly if securities are purchased on an installment contract, it is important to set up as an asset the full cost of the securities."

Although the foregoing excerpt concerns the installment purchase of securities for investment purposes, nevertheless, we believe the conclusion expressed regarding the preferability of setting up the total contract price and correlative liability is equally relevant to the case described in your letter, i.e., a transaction involving the redemption or installment purchase of a portion of its own issued stock by a closely-held corporation, with the additional feature that delivery or surrender of the stock certificates to the corporation is deferred by virtue of their having been placed in escrow.

In our opinion, either of the two presentations or treatments outlined in your letter (with possible minor deviations) is acceptable. However, our own personal preference runs to the first presentation. Thus, in our opinion, Treasury Stock may initially be recorded at the total contract price with a correlative credit to Installment Contract Payable – Treasury Stock. A possible technical refinement would be to set the Treasury Stock and obligation up in terms of the present value of the series of payments to be made. It would be proper to segregate the current portion of the liability at balance-sheet date, as you have done. If a collateral note or serial notes were in fact given by the purchaser or if the mortgage is in the form of a "mortgage note," then the liability might be designated "*Note(s)* Payable," etc.

A footnote keyed to the liability and treasury stock accounts in the balance sheet should succinctly set forth salient or essential features of the stock purchase agreement. As you have indicated, the footnote should include reference to the mortgage encumbrance, to any restriction upon retained earnings, and to the portion of treasury stock held by the escrow agent.

Follow-Up Inquiry

"Thank you for your recent letter giving your opinion on our problem of the presentation of the installment purchase of a portion of its own issued stock by a closely-held corporation.

"In your opinion, presentation No. 1 is preferable and you state that presentation No. 2 would be acceptable.

"After reading your opinion and re-evaluating the problem, we would like to have a more detailed opinion on the second presentation.

"It is our feeling that the second presentation does not fully set forth the position of the corporation even though it discloses the essential features of the stock purchase agreement.

"Our reasons for this conclusion are:

1. The stockholder has entered into a firm contract with the corporation to sell to the corporation all of his stockholdings at a definite sum of $45,000.
2. The corporation has given the stockholder as collateral security for performance a third mortgage on the properties of the corporation.

"We feel that the above features establish a definite liability of the corporation to pay the contract price over the length of the contract, and that in event of default, the stockholder can foreclose the mortgage to compel fulfillment of the contract.

"For this reason we do not feel that the transaction can be shown under presentation No. 2 as a contingent liability.

"We would appreciate your further views on this matter."

Our Final Opinion

Lavine's *Modern Business Law* (Prentice-Hall, Inc., N.Y., 1954, at p. 552) states the following:

> Right of corporation to buy its own stock. Some states (Washington, Missouri and California, for example) have held that a corporation cannot purchase its own shares of stock either to retire or to reissue them. The better rule, however, is that a corporation may acquire and hold its own stock, provided:
> (a) The transaction is fair and made in good faith.
> (b) The transaction is free from fraud.
> (c) The rights of creditors and other stockholders will not be prejudiced by the purchase.
> (d) The purchase is made out of an existing surplus.
> (e) The purchase will not cause the corporation to lose its surplus nor to become insolvent.
> (f) The corporation is not in the process of dissolution.
>
> Corporate commitment v. corporate option to buy stock. An agreement by a corporation that *obligates* it to purchase its own

> stock in the future, either at a definite time or upon a contingent event, is unenforceable because at such future time the corporation may not have a surplus, in which event it could not be compelled to buy the stock. Since such an agreement would lack mutuality, it would be void from the start. [New York case cited]

In view of the statements made in the last quoted paragraph, we have considerable doubt as to the validity of the legal conclusions cited in your latest letter as reasons for the impropriety of presentation No. 2. As a matter of fact, in the light of Lavine's comments, we are now inclined to withdraw our originally expressed preference for presentation No. 1 in favor of presentation No. 2.

Author's Afterthoughts

Many courts might not hold to as strict a view of the corporate commitment to purchase its own stock in the future as that of the New York court. Rather, they *might* hold the contract *voidable* for balance unpaid only at the point where the purchasing corporation's surplus is reduced to zero. Subsequent to this latter exchange of correspondence, the new *New York Business Corporation Law* became effective (i.e., in September, 1963). It appears that the New York case cited by Lavine (which held the corporate contract for the future purchase of its own stock void from its inception) may now have been superseded by the new statutory provisions, viz.: In general, a corporation may never purchase or redeem its shares if it is insolvent or would thereby be made insolvent (section 513(a), (b), (c)); otherwise such purchase or redemption may be made out of surplus at any time (section 513(a)). More specifically, an agreement by a corporation to purchase its own shares is enforceable by the shareholder if at the time for performance the corporation might lawfully have purchased the shares in the absence of an agreement (section 514(a), (b)). Thus, the *possibility* that the corporation might at such time not have been able to perform apparently does not vitiate the agreement.

In further support of presentation No. 2, quite apart from any questions of *validity* or *enforceability* of the contract in question, one *might* argue that the purchase of stock should be accounted for piecemeal, the deposit account being periodically reclassified as treasury stock and reflected in the equity section when and as blocks of shares are released from escrow upon full payment therefor. A rationale underpinning this treatment would be interpretation of the contract as a *divisible* or *severable* contract rather than as a contract entire. The provisions for release from escrow would seem to support such an interpretation. Furthermore, in support of presentation No. 2, it *might* be stressed that, under the classical interpretation of an escrow, "title" (or "property in" the shares) does not pass until the purchaser meets all conditions precedent and the escrow agent thereupon releases the property.

Incidentally, regarding the quotations from the *Accountants' Handbook* and from *Finney and Miller*, appearing in our initial reply, we believe the reason why setting up the full liability on the margin purchase of securities can be supported is that the broker purchases the securities outright in the customer's name; therefore, the latter becomes liable for the full purchase price. However, where securities are purchased on an installment contract for investment, we personally feel that the question whether full cost and full liability should be set up should depend on whether a "true" subscription (a "present subscription") or a contract to purchase stock (i.e., an executory agreement), is involved. In the former case, the subscriber becomes immediately liable for the full purchase price; in the latter case, the would-be purchaser, upon his default, is liable for damages, if any, for breach of contract.[1] Incidentally, *default* clauses requiring payment forthwith of the entire unpaid balance of the contract price may be vulnerable from the standpoint of enforceability on the ground that such provision constitutes a *penalty* rather than an adequate measure of actual damages sustained.

Inquiry 414

Adjustment of treasury stock cost by amount of indemnification payment from appraisal company

"One of our corporate clients bought some of its capital stock held by two stockholders. The price was presumed to be based on book value, as such book value would be affected by an appraisal of the

[1] See Lavine's *Manual on Commercial Law* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958) at p. 338, and at bottom of p. 339, top of p. 340.

fixed assets. Such appraisal increase was to be added to the book value determination to arrive at a valuation per share of the outstanding capital stock, and to be the basis for purchase of the stockholders' shares.

"An appraisal report was submitted by a national appraisal firm, and such report was relied upon to purchase the stockholdings; the purchase was completed on the basis of each share so based on book value augmented by the appraisal increase.

"Sometime after the sale was made, it was discovered by the corporation that the appraisal company made an error of considerable amount in stating the accrued depreciation on one of the buildings involved. This resulted in the corporate client's having paid more for such treasury stock than it would have paid otherwise. After demand for recovery was made on the appraisal company, settlement was agreed to for about one-half of the amount claimed as overpayment for such treasury stock.

"Now, I should like your opinion as to whether the amount of recovery in this instance is taxable income, or if the recovery is to be credited to treasury stock inasmuch as the treasury stock would have cost less had the appraisal been correct in the first instance."

Our Opinion

As a matter of Institute policy we do not undertake to give opinions on the tax aspects of questions submitted.

From the standpoint of "generally accepted accounting principles," however, it is our opinion that the recovery should be credited to treasury stock as an adjustment of the purchase price or cost of the treasury shares. We rather look upon the recovery as an indemnification payment to reimburse the client partially for an exorbitant cost incurred for the stock of the retiring shareholders. Accordingly, we feel the amount in question should be applied as an abatement or reduction of the previously recorded expenditure in order to reflect the treasury stock at effective cost.

Inquiry 415

Stock retirement (survivor-purchase) agreement funded by cross-purchase of insurance policies — preserving parity of burdens and benefits of two 50 per cent stockholders

"I have been requested to obtain an opinion concerning a distribution of expense for one of my clients. The client is an average-sized corporation in which the total stock is owned equally by two individuals who are active and devote one hundred per cent of their time to the company's business.

"Each of the two stockholders has acquired life insurance on the life of the other stockholder with himself as the owner and beneficiary of the policy. The proceeds of the policies are to be used as a down payment on the purchase of the other person's stock in said client corporation, in the event of his death.

"Because of the differences of age and health of the two stockholders, there is considerable difference in annual insurance premiums. The following conflict has arisen: Should each of the stockholders pay one-half of the total premium on the life of the other, or should each stockholder pay the premium on the policy he owns on the life of the other?

"The difference of opinion arises because one of the stockholders feels that they are acquiring protection for the corporation as well as protection for the widow of the deceased stockholder as required by the stock purchase agreement and, since they are acquiring money for her benefit, they are being protected and the premium should be divided equally.

"The other stockholder feels that because it is probable that the person on whom the highest premium is paid will die first, the difference in rate is reflected in potentially receiving the money sooner and, therefore, the premiums should be charged according to the actual rate."

Our Opinion

As a matter of Institute policy we do not undertake to give opinions on the tax aspects of questions submitted; and it goes without saying it is rather unrealistic to discuss buy-and-sell or survivor-purchase agreements in a tax void. However, we will attempt to express as helpful and constructive an opinion as possible under the circumstances.

Perhaps, at the outset, it is well to stress the fact that a stock retirement agreement funded by the cross-purchase of insurance policies on the lives of the principal stockholders has *dual* and *mutual* objectives, viz.:

1. To guaranty obtention of the decedent's interest in, or retention of control of, the corporation, to the surviving stockholder, and
2. To assure availability and payment of insurance proceeds to the decedent stockholder's estate (in consideration of the transfer of the decedent's stock) to provide the wherewithal to the family of the decedent to help pay any estate tax and immediately realize in the form of liquid assets the value of the decedent's interest in the business (or portion thereof).

In the situation in question, as far as ownership interest in, and time devoted to, the business are concerned, there is a parity between the two stockholders. If we do not also assume that the two stockholders are on a par as to general or special competence, then perhaps we may assume that any difference in competence and value to the business is recognized through salary differentials. Age and health, then, are the principal variables making for a lack of parity as between the two stockholders, with the result that the younger of the two men bears a disproportionately greater share of the insurance premium payments made to fund the agreement.

One possibility here, it seems, would be for the parties to continue their premium payments on the same basis as at present, and upon the death of one of the stockholders, have the personal representative or executor of the decedent's estate make a settlement with the surviving stockholder to equalize the cumulative premium payments made, resorting to the cash surrender value of the policy on the life of the surviving stockholder (after estate tax applicable thereto) for such purpose. Provision for such settlement might be made by an amendment or modification of the parties' existing agreement. Thus, assume a business with net assets of $100,000 with the two principals each owning 50 per cent of the stock and each carrying a $50,000 policy on the other stockholder's life. Assume further that at the time of the death of, say, the older stockholder, the latter had paid $6500 in premiums on his policy on the life of the younger stockholder which policy has a cash surrender value (net of any estate tax) of $4500.

Assume also, at such time, the younger stockholder's cumulative premiums totaled $12,500. Total premiums paid equal $19,000, and on a 50/50 basis, each would have paid $9500. Thus, to restore the parties (or their successors in interest) to a parity respecting premium payments, $3,000 of the C.S.V. might be settled on the surviving stockholder, and the remaining $1500 of C.S.V. divided equally between the estate and the surviving stockholder.

Doubtless, there are a number of other aspects of this question relating to the assurance or maintenance of a parity of benefits as between the two principals which should be discussed. One such aspect is the following, viz.: If the purchase price for the interest of a stockholder has already been *fixed* or *pegged* by the agreement, the surviving stockholder would have a windfall to the extent that the fair value of the decedent stockholder's interest in the business at the time of his death exceeds the cumulative insurance premium payments made by the surviving stockholder plus any excess of the purchase price over the insurance proceeds which the surviving stockholder may have paid. An agreement should contain a provision to protect the decedent stockholder's estate from suffering a loss in the event of such contingency.[1]

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[1] For whatever additional light they may throw on your client's situation, see the following references:

1. "The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death" (vol. 71, *Harvard Law Review*, pp. 687-712, 1958).
2. "Problems in Drafting a Stock Purchase Agreement Relating to the Death of a Stockholder in a Closely-Held Corporation," by J. S. Pennell (*Marquette University Institute on Taxation*, pp. 100 *et seq.*, 1956).
3. "Further Victories for Buy-and-Sell Agreements," by Kamens and Ancier (in Summer, 1956 issue of *The Journal of the American Society of Chartered Life Underwriters*, at pp. 211-17).
4. "Business Buy-Out Agreements with Life Insurance Under the New Code," by R. J. Lawthers (in Winter, 1954 issue of *The Journal of the American Society of Chartered Life Underwriters*, at pp. 73-85, and 90).
5. "Recent Developments in Business Purchase Agreements," by D. C. Davis (in April, 1955 issue of *Trusts and Estates*, at pp. 284 *et seq.*).
6. "Case Study in Use of Buy and Sell Agreements," by H. S. Voegelin (in December, 1957 issue of *Trusts and Estates*, at pp. 1189 *et seq.*). For its bearing on the question whether it would be prudent for the stockholders currently to share the premium payments on a 50/50 basis, see under "Funding Purchase" at p. 1190.

Inquiry 416

Establishment of employees' stock trust by closely-held corporation, after latter's purchase of own stock to prevent outside interest from gaining control

"We would appreciate your assistance in determining the proper method of presenting reacquired stock in the financial statements of one of our clients, based on the following facts:

"X is a closely-held corporation (organized in Colorado), and there have been no stock transactions in recent years. In 1960, a large block of stock was acquired by an outside interest at a price approximately 222 per cent of book value. In order to prevent this outside interest from possibly gaining control of the corporation, X reacquired 20.8 per cent of the outstanding shares at a price of approximately 240 per cent of book value. To finance this purchase, X sold some of its investments and borrowed additional funds from a bank, pledging the reacquired shares as collateral.

"X is considering setting up an employees' stock trust, which will purchase reacquired shares from X and will in turn sell trust shares to participating employees. The initial sale to the trust would be for approximately 20 per cent of the reacquired shares at a price of 240 per cent of book value, but a stockholder will contribute an equal number of shares to the trust, making the effective cost to the trust only 120 per cent of book value. The trust will pay for these shares over a period of five years. No further sales are contemplated for at least five years, and it is possible that the price at that time might not exceed 50 per cent of the cost of the reacquired shares, inasmuch as management feels that this is a more realistic valuation, the purchase at 222 per cent having been an attempt to acquire control.

"Inasmuch as the shares are pledged to secure the loan and may also be sold to an employees' trust (permissible under the loan agreement since proceeds will be used to retire the loan), X wishes to show these reacquired shares as an asset. If the reacquired shares are shown as an asset, they would represent approximately 30 per cent of the total assets. Our research indicates that this is permissible *if* the shares are reacquired specifically for resale to employees.

"Your opinion is requested on the following:

"1. Is there justification for showing these reacquired shares as an asset?

"2. Would there be a difference in the answer to '1' if the trust plan had or had not been formally adopted at the balance-sheet date, which is later than the date of acquisition?

"3. If the answer to '1' is 'yes,' what valuation should be used for the reacquired shares in view of the fact that future sales might be at 50 per cent of cost?"

Our Opinion

Since Corporation X is organized as a Colorado corporation, we would first of all seriously suggest that you see section 5 of the *Colorado Corporation Act* dealing with "right of corporation to acquire and dispose of its own shares," which section may be relevant in connection with the problem set forth in your letter.

We will assume Corporation X has met the requirements of the statute in acquiring the treasury shares, i.e., that there was sufficient surplus to cover the purchase of 20.8 per cent of the outstanding shares of the corporation's own stock, the amount of the consideration therefor apparently representing 49.92 per cent of the total book value of the net assets of the corporation. *If* the consideration paid by Corporation X for the shares did in fact exceed its surplus, and *if* the effect is to make the transaction a nullity, the alternative of having the employees' trust or a syndicate or association of employees directly purchase the shares from the party purporting to sell such shares to Corporation X should be explored. Also, *if* Corporation X impaired its capital by such purchase, then possibly the trust should undertake and be obliged to pay over to the corporation, as a *minimum,* the amount of the consideration paid by Corporation X in excess of its surplus.

Especially since the statute restricts surplus in the amount paid for the reacquired shares, we personally believe the preferred treatment should be followed of showing the treasury shares in the net worth section of the balance sheet at cost, as an unallocated deduction from the sum total of capital stock and surplus. In any event, a note to the financial statements should disclose the restriction on surplus.

However, an apparently permissible alternative to this treatment for treasury stock is indicated at p. 426 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), viz.:

> ... Treasury stock is usually deducted from total capital, at cost;

> but if it has been acquired for the specific purpose of resale to employees or others, it is permissible to show it separately on the asset side of the balance sheet, at cost, provided the reason for the treatment is disclosed in the balance sheet or in a note thereto.
>
> The laws of many states provide that treasury stock may be purchased only when the purchase does not impair legal capital; in some states surplus available for payment of dividends or other purposes is restricted in the amount of the cost of treasury stock. Such restriction should be disclosed in a note to the financial statements.

Regarding your second specific question, it seems to us the case for indulging the exceptional treatment thereby reflecting the treasury stock as an asset would be somewhat strengthened if the trust plan had been formally adopted at balance-sheet date.

Regarding your third specific question, if the item *is* treated as an asset, and there is a realistic prospect that only 50 per cent of cost is recoverable on eventual disposition, then we believe the impairment in value as in the case of any other "asset," should be immediately recognized as a loss, the writeoff, however, being charged to surplus since treasury stock is involved. On the other hand, if the item is treated as an unallocated deduction from the sum total of capital stock and surplus in the capital section, then we would not be inclined to write off the portion of cost deemed irrecoverable at this time because the entire cost is being reflected as a reduction of total capital elements.

Inquiry 417

Treasury shares "earned" by distributor-customers but undistributed at balance-sheet date by company sponsoring sales promotion program

"Under the heading 'Treasury Shares Not An Asset,' the *Accountants' Handbook* (Ronald Press Co., N.Y., 1943, at pp. 1008-09) states in part:

> The view that treasury shares constitute a recognizable corporate asset under some conditions is still common. However, the case against this interpretation is convincing. . . . The fact that the shares may shortly be reissued is not important as there might

> also be an intention to issue shares which have never been issued, and no one would argue that such intention would justify treating the authorized shares as an asset. . . . the special circumstances claimed as justifying the exceptional showing of treasury shares as assets, such as acquisition of shares for employee bonuses or with the intention of reissuing the shares, and holding of shares in a sinking or allied fund, do not warrant departure from the generally accepted policy. . . . there should be no exception to the rule that treasury shares should not be dealt with as an asset, . . . etc.

"*Montgomery's Auditing* (Ronald Press Co., N.Y., 1949, at p. 409) states:

> . . . Treasury stock is usually deducted from capital, but if it has been acquired for the specific purpose of resale to employees or others, it is permissible to show it separately on the asset side of the balance sheet, at cost; the reason for the treatment should be disclosed in a note to the balance sheet.

"My associates and I would be most interested in your opinion as to the proper balance-sheet presentation of treasury stock under the following circumstances:

"Stock is purchased on the open market pursuant to a sales promotion program for distributor-customers of the company. The program provides that shares will be earned upon delivery of merchandise ordered in certain minimum quantities. Orders must be received between October 1 and November 30, 19. . . ., to be eligible for shares of stock. A registration statement is filed with the Securities and Exchange Commission outlining the terms of the program under which the stock is to be issued. It was estimated that approximately 1 per cent of the company's outstanding stock would be required for the program. This quantity was purchased in September, 19. . . ., at a cost of $500,000. At December 31, 19. . . ., 25 per cent of the stock had been earned and issued; an additional 50 per cent had been earned but was not issued; the remaining 25 per cent was not earned. It was decided that this 25 per cent would be held for issue in the following year under a similar sales promotion program.

"Will you please give us your opinion as to the preferred balance-sheet presentation of:

1. The portion of the stock earned but not issued (50 per cent).
2. The portion of the stock not earned (25 per cent).
3. The liability for the 50 per cent portion in '1' above."

INQUIRY: 417

Our Opinion

We would be inclined to treat the portion of the stock earned but not released or transferred as if it were in fact outstanding at balance-sheet date. Thus, at balance-sheet date, an adjusting entry should be made, debiting advertising and promotion or a similar expense account and crediting treasury stock with the cost of stock earned but not released. The number of shares reflected as outstanding, which are in custody of the company but subject to imminent distribution at balance-sheet date, should be indicated in a footnote to the statements.

We believe the going-concern and accrual-basis concepts would support such treatment, and if the earned shares had in fact been distributed before issuance of the audit report, then *Statements on Auditing Procedure No. 25, Events Subsequent to the Date of Financial Statements* (AICPA, 1954), par. 9,* would support our recommended treatment on grounds we are dealing with an "adjustment-type" subsequent event. The company's obligation is not primarily a monetary one but rather a contractual obligation to deliver shares when certain conditions precedent have been met by distributors pursuant to the sales promotion program as established and offered. This is not a case of reflecting the shares in question on an "as if" basis; substantively, the distributors' entitlement to the shares has *accrued,* the company now holds the shares as a "resulting trustee," and all that is left to be done is the ministerial task of delivering the shares. This case is analogous to the case where a *present sale* is recorded as such even though merchandise is retained on the selling company's premises being held for future delivery. It is also analogous to the case of a *true stock subscription,* i.e., a present subscription to shares where the subscriber immediately on acceptance of the subscription has all the rights and obligations of a stockholder, and where the subscribed stock is deemed "issued" even though certificates remain to be delivered.

Possibly the contention that the remaining 25 per cent of the treasury stock may be shown as an asset in the year-end balance sheet further described as prepaid advertising and promotion expense, would have some support. However, we personally would be inclined to reject such a presentation in favor of reflecting such treasury stock at cost as a deduction from the sum total of capital stock and surplus. The

* Cf. *Statements on Auditing Procedure No.* 33 (AICPA, 1963) p. 76, par. 6.

footnote referring to the number of earned but undistributed shares included in outstanding stock could also refer to the fact that the remaining treasury stock is being held for prospective distribution under the terms of the company's promotional plan.

Incidentally, for discussion of appropriate treatment in a somewhat analogous case where a stock dividend was declared prior to, but made subject to issuance after the balance-sheet date, see Carman G. Blough's column at pp. 84-5 of the July, 1949 issue of *The Journal of Accountancy.*

Inquiry 418

Disclosure and presentation with respect to stock purchase agreements

"We have been encountering a number of agreements whereby it is required that firms purchase stock of a deceased or retired stockholder and that this stock be retired.

"Our question, now, concerns the approved way to carry this on the balance sheet, as we feel that the restriction of having to retire the stock means that they cannot reissue it, and it would also mean that they cannot reissue any shares to replace the amount of such retired stock. On the other hand, it might be that this merely becomes treasury stock to be held in the company treasury and available for future sale."

Our Opinion

We are not entirely certain from your letter whether you are principally concerned with the proper presentation of the stock after it has been acquired pursuant to agreement from a retired stockholder or personal representative of a deceased stockholder *or* whether your question concerns the necessity for disclosure of the agreement requiring purchase of the stock in the corporation's statements prior to actual retirement or death of a stockholder.

To take the last question first, in our opinion, the rule of informative disclosure would require disclosure of the essential terms of the agreement or commitment in any case where a corporation is funding a stock purchase agreement by purchasing insurance on the life of an officer-stockholder, or in any case where a corporation is party to an agreement *requiring* that it purchase the stock upon the occurrence or happening of specified contingencies or events certain to occur.

On the other hand, if the corporation merely has a first-purchase option on an officer-stockholder's shares which it may or may not exercise prospectively, then, in such situation, we do not regard disclosure as mandatory.

Regarding balance-sheet presentation of the stock once it is actually acquired pursuant to agreement, in our opinion, such stock should be reflected at cost as an unallocated reduction of the sum total of capital stock and surplus until it is either restored by proper charter proceedings to the status of authorized but unissued shares or formally retired by charter amendment. In the latter case, the reduced number of authorized shares would have to be indicated in the balance sheet. In doubtful cases, a legal opinion should be obtained as to whether the action of the board results in a reduction of the authorized number of shares.[1] Apparently on the ground that stock purchased *for* retirement would have the status of treasury stock only temporarily, the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, at pp. 21.35-6) recommends the following acceptable alternative procedure, viz.:

> After procedures have been agreed upon for the selection of shares to be retired, state statutes usually will specify the procedures to be followed in the retirement of common shares. If shares are acquired for retirement under the regular procedure, the shares either do not have the special status of treasury stock, or have such status only temporarily. Accordingly, the accounting for the acquisition of a block of shares for retirement should involve direct charging of capital accounts (including paid-in "surplus") and immediate recognition of the underlying effect of the

[1] For material relating to the status of reacquired shares, see *The Law of Accounting and Financial Statements*, by G. S. Hills (Little, Brown & Co., Boston, 1957) at pp. 141-5. Note the statement at p. 141 that "Shares purchased or redeemed . . . remain authorized until retired by charter amendment, even if the corporation has covenanted not to reissue or sell them." For additional relevant material, see sections 60 through 62 of the *Model Business Corporation Act* (American Law Institute collaborating with American Bar Association, revised, 1953).

difference between the amount paid for the shares and their paid-in value. Such analysis requires charges to the various paid-in capital accounts (par or stated value accounts, and accounts for any excess over these amounts) for the average amount paid in on the number of retired shares. The difference between cost of shares and their paid-in value is reported either as a special paid-in capital account (if paid-in value exceeds cost) or as a deduction from retained earnings (if cost exceeds paid-in value). The retirement of shares which have been carried for a time as treasury stock, in a type of suspense account, follows precisely the same pattern.

Inquiry 419

Sale and repurchase of its own fixed assets by corporation, involving transfer of stock ownership, assumption of liability, and impairment of capital

"We would appreciate your consideration of the proper balance-sheet presentation of treasury stock reissued at a discount.

"In a sale and repurchase agreement, the sole owner of a small corporation sold the fixed assets to the purchaser for $250,000, receiving $125,000 cash and a note for $125,000. The sole owner surrendered the entire capital stock (2500 shares, par value $250,000) in exchange for the liquid assets of the corporation. The purchasers of the fixed assets transferred the assets, subject to the note, to the corporation and were issued the 2500 shares of stock.

"As the books now stand, there are fixed assets of $250,000, a current liability of $125,000, and capital stock issued and outstanding with a par value of $250,000.

"We have made the suggestions to the legal advisers of the corporation that the charter be amended to allow for no-par stock to be issued to replace the par stock or to reduce the number of shares now outstanding; but for the present, we would like to know the proper way to present the net worth section of the balance sheet."

Our Opinion

Assuming there are no balances in the surplus accounts, we believe a proper way to present the net worth section of the balance sheet would be as follows:

Capital Stock (2500 shares issued and outstanding; par value $100 per share)	$250,000
Less: Capital Impairment Representing Difference Between Purchase and Resale Prices of Outstanding Capital Stock	125,000
Net Capital	$125,000

The foregoing assumes that by the phrase "subject to the note," you mean "subject to a mortgage securing the note – or to mortgage terms incorporated in the note itself," and accordingly, that it is proper to reflect a liability of $125,000 upon transfer of the property back to the corporation. However, if the fact is that the note is not secured by the property itself by virtue of a mortgage, then it would appear that upon the former owner's surrender of his shares, the corporation would have "negotiated" the note to the former owner and thus would be only contingently liable as an endorser of the note. Under the circumstances, the contingent liability should be disclosed but a $125,000 liability should not be reflected in the accounts proper. Furthermore, it would presumably not then be necessary to reflect any capital impairment.

The foregoing, of course, also assumes an arm's-length transaction.

Follow-Up Inquiry from Same Correspondent

"Recently I wrote to you requesting your advice on the balance-sheet presentation of what I considered a discount on sale of treasury stock. Judging from your reply, I believe that I failed to present the facts as clearly as I should; therefore, I would like to try again.

"My clients negotiated a two-phase agreement with an existing corporation. By the use of journal entries and 'T' accounts, I will attempt to reflect the important aspects of this agreement. To simplify the explanation I am using round figures rather than actual amounts involved.

"The fixed assets of the corporation were sold to my client for the sum of $250,000 – $125,000 paid in cash, and the buyer's personal notes were issued for the balance. A mortgage was issued on the fixed assets to secure the notes. The corporation's journal entries and 'T' accounts for this transaction are summarized below:

Dr. Cash	$125,000	
Notes Receivable	125,000	
Cr. Fixed Assets		$250,000

Cash		Notes Rec.		Fixed Assets		Capital Stock	
(1) 125,000		(1) 125,000		250,000	(1) 250,000		250,000

I have assumed here that the fixed asset debit balance and the capital stock credit balance were existing balances.

"The entire stock of the corporation was owned by one person. After the sale of the fixed assets, the sole owner surrendered all of the stock for the current assets of the corporation and assumed the liabilities of the company. This transaction is illustrated by the following entry on the corporation's books:

Dr. Treasury Stock	$250,000	
Cr. Cash		$125,000
Note Receivable		125,000

Cash		Notes Rec.		Treasury Stock		Capital Stock	
125,000	125,000	125,000	125,000	250,000			250,000

The notes issued by my clients were endorsed without recourse by the corporation and surrendered to the previous owner of the stock.

"The second phase of the agreement provided for the corporation to repurchase the fixed assets from my clients. As consideration, the corporation was to issue capital stock with a par value of $250,000 which was then held as treasury stock, and as additional consideration the corporation contracted to assume the $125,000 indebtedness as evidenced by the notes and as secured by the mortgage on the fixed assets. It would seem that this transaction should be journalized as follows:

Dr. Fixed Assets	$250,000	
Discount on Sale of Treasury Stock	125,000	
Cr. Treasury Stock		$250,000
Notes Payable		125,000

Fixed Assets	
250,000	

Notes Payable	
	125,000

Treasury Stock	
250,000	250,000

Discount on Sale of Treasury Stock	
125,000	

Capital Stock	
	250,000

"In your previous reply, you suggested that the liability for the $125,000 note might be shown as a contingent liability rather than in the accounts proper. I believe that you were considering the liability to the corporation that arose when the notes (held as an asset) were negotiated to the former owner. The liability shown above was assumed as a part of the consideration in the purchase of the assets from my clients. In view of the facts as stated, that the notes were assumed by the corporation as part of the consideration in the purchase of the fixed assets and that the fixed assets were subject to a mortgage securing the notes, do you see any way that the $125,000 liability might be omitted from the accounts proper, and would you suggest whether you would change the balance-sheet presentation of the capital stock as shown in your previous reply?

"This was a completely arm's-length transaction."

Our Final Opinion

In our prior letter we concluded that the $125,000 would be a contingent rather than an actual liability only "if the fact is that the note is not secured by the property itself by virtue of a mortgage" encumbrance thereon. We should have added "or if the corporation did not directly assume the new stockholder's personal obligation on the notes." Your current letter clearly indicates that neither of the "ifs" apply; i.e., the corporation did in fact directly assume the obligation on the notes, and the fixed assets in question are in fact subject to a mortgage. Accordingly, unless, say, upon intercession of a creditor the resale of the treasury stock and assumption of the obligation on the notes was deemed to be void, we do not see any way in which the $125,000 may properly be omitted from the corporation's accounts. Furthermore, in the absence of any surplus and pending possible reduction in the legal or stated capital of the corporation which would result in a "reduction surplus" sufficient to absorb the difference between the cost of the treasury stock ($250,000) and the net consideration received therefor upon resale ($125,000), we see no reason for changing the balance-sheet presentation of the capital stock as shown in our previous letter.

We have considered the alternatives of reflecting the *difference* between the cost of the treasury stock and the net consideration received therefor (i.e., fixed assets less the notes payable) as a *receivable* from the new stockholder *or* as *stock discount.* We have some difficulty from a technical standpoint in referring to the difference in question as "stock discount." Ordinarily, stock discount does not arise in connection with the resale of treasury stock, since "In the disposition of treasury stock, the corporation is not controlled by the provisions of the constitution, statute, or charter regulating the amount of the consideration for which stock of an original issue must be sold. The corporation may sell treasury stock for whatever price it can get for it, or it may give it away as a bonus . . ." (see p. 2140, vol. 1 of Prentice-Hall, Inc.'s *Corporation Report* service).

At the risk of understatement, the sale and repurchase agreement described in your letter raises some interesting questions as to legal effects.[1] One question involves the *right* (apart from the *power*) of the corporation to purchase 100 per cent of its outstanding stock in the first instance, especially if it had no earned surplus. Query also whether the corporation was then defunct at the time it acquired its entire capital stock; also who had the right or authority to resell the treasury stock since a corporation may not vote its own shares? Is it presumptuous to say here that the tax motivation of the transactions is trans-

[1] In this connection, see "Purchase of a Corporation with Its Own Assets or Earnings," by Furman Smith (in *The Practical Lawyer* for February, 1955, at pp. 43-52). See also "Purchase of a Corporation with Its Own Assets or Earnings — Revisited" (*ibid.* and *idem,* March, 1965 issue at pp. 15-24).

parent? Is the purported sale and repurchase of fixed assets fairly to be described as "colorable," a "step transaction," or a "wash"? Did the corporation ever acquire "treasury shares," i.e., is the purported transfer of 100 per cent of the stock to the corporation abortive or void from the beginning? Again, does a corporation have the *right* (as distinguished from the *power*) to encumber its assets to secure payment of a new stockholder's *personal* obligation to an old stockholder? Or would this be construed as a "wasting of corporate assets," i.e., upon actual payment? Is the substance of the series of transactions a sale of the stock by the old to the new stockholder for cash and the latter's note? Also, we considered the fact that corporations generally are prohibited from *purchasing* their own shares or *declaring dividends* if the result is to impair legal capital, and this led to the question *whether a board may resell its treasury stock for a consideration materially less than its cost if such resale results in impairment of its legal or stated capital.* Such considerations as the foregoing compelled us to entertain the necessity of reflecting the difference in question as a *receivable* from the new stockholder or setting off such difference against the liability. We concluded in favor of our previously suggested presentation of the capital stock account mainly because we assume no existing creditors' rights were affected since you state in your letter that the old stockholder "surrendered all of the stock for the current assets of the corporation and *assumed the liabilities of the company*" (*our emphasis*).

Inquiry **420**

Corporation's "borrowing" its own stock from president, and subsequent sale thereof

"One of our clients has borrowed 10,000 shares of no-par capital stock from its president. This is the corporation's own stock.

"Subsequently, the corporation has sold a considerable number of shares of this borrowed stock to other investors. The stated value of the original 10,000 shares was ten cents (10¢) per share. The corporation has disposed of this stock in various blocks at prices varying from $6 to $12 per share.

"Our problem is: What is the proper manner to reflect the borrowing of the 10,000 shares and the subsequent sale of the stock on the balance sheet of the corporation?"

Our Opinion

In our opinion, the accounting treatment and financial presentation of the transactions briefly described in your letter are basically dependent upon their legal effect. We are not in a position to state what the legal effect is. However, the following comments may help to clarify the problem.

If the facts attending the transfer of the shares to the corporation warrant construing the transaction as a *gift* or donation of the shares, then see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, second and third paragraphs, p. 394) regarding treatment as paid-in surplus, of the proceeds from resale of donated treasury stock.

However, if the facts indicate that the president intended to make a *loan* of the shares to the corporation, then an attempt should be made to determine the purpose of making the loan and the circumstances and conditions surrounding the transfer of the shares to the corporation. We recognize the inherent difficulty here because we presume very little, if anything, was reduced to writing.

Bouvier's *Law Dictionary* (Banks-Baldwin Law Publishing Co., Cleveland, 1946, q.v.) characterizes and distinguishes between two basic types of loans or bailments, viz., the "loan for consumption" and the "loan for use." In the so-called "loan for consumption," the property (i.e., title) in the thing loaned passes to the borrower, and the thing loaned need be returned to the lender only in kind or equivalent. In the so-called "loan for use," the property (i.e., title) in the thing loaned remains in the lender, and the specific or very thing loaned must be returned to the lender. The basic nature of the *former* is that of a *sale or exchange,* according to Bouvier.

If the legal effect of the initial transfer of shares described in your letter is that of a "loan for consumption" (read "sale or exchange"), then, in our opinion, the shares in question may properly be treated as treasury stock and a corresponding liability to the president reflected in the corporation's balance sheet. However, depending on the nature and amount of the consideration for which the corporation is deemed obligated, possible immediate tax effects may then be involved, i.e., from the president's standpoint. On the other hand, if the transaction described in your letter is construed as a "loan for use," then, in our opinion, it would be improper to reflect the shares in question either as an asset or as treasury stock in the corporation's balance sheet. Transfer of shares to a corporation to enable it to collateralize a loan from a bank may be a prime example of a "loan for use" as defined above. It is patent that if a transfer for the latter purpose were made to a corporation, the corporation might have the power but *not the right* to sell the shares. To summarize our viewpoint on this aspect: If a bailment or consignment of the shares in the classical sense is involved, then the corporation should not recognize the shares as an asset or as treasury stock; if a sale or exchange of the shares is involved, then the corporation may recognize the shares in question as treasury stock.

Assuming that the transfer is interpreted as a "sale or exchange" and that the manifest intent in transferring the shares to the corporation is that the president is to be paid back only his original capital contribution (presumably 10¢ a share), then the treasury stock and obligation would be set up at that amount, and upon resale of the treasury stock to the other investors, the proceeds in excess of the original capital contribution would be credited to paid-in surplus. However, if the intent is that the president is to receive back something more than his original capital contribution, say even the entire amount paid in by the new investors, then a further dilemma arises, viz.: May any portion of the proceeds from sale of treasury stock in excess of the carrying value of such treasury stock be properly credited to an account other than a capital account? Assuming, *arguendo,* that the total amount to be paid in by the other investors had been known in advance and both the treasury stock and a liability to the president had been set up in the first instance at that amount, the question would still remain, whether upon resale of the treasury stock, the president may be estopped from asserting *any* claim against the corporation on the grounds that the new investors were bona fide purchasers of the stock without notice of the fact that the corporation had obtained the shares from the president and intended to pay over the entire proceeds from sale of the shares to him personally. The new investors may have bought into the corporation under the impression, fostered or not, that the money would be used in the corporation's operations.

Of course, if the intent from the outset was that the corporation took the shares merely as the agent of the president to effect a sale of the shares in his behalf and for his account, and if the new investors had knowledge of this fact, then it seems clear that no treasury stock should be set up on the corporation's books upon initial transfer of the shares, and that upon selling the stock, the corporation should debit the proceeds to cash and set up an agency obligation or liability to the president.

Initial Inquiry 421

Tripartite agreement for purchase of old stockholder's 50 per cent interest — involving "advance" of portion of total consideration by new stockholder to corporation, followed by disbursement thereof to old stockholder

"I am writing to request advice on a difficult accounting problem.

"I have a client corporation whose December 31, 1962, balance sheet showed total assets of about $1,000,000, and total liabilities of about $1,020,000; capital stock was $140,000 and accumulated deficit was $160,000. This corporation was then owned in approximately equal proportions by two individuals.

"Early in January, 1963, one of the owners, who had not been active in management, sold his interest to a third party, a corporation. The transaction was rather involved, but I believe that all of its phases can be satisfactorily accounted for, except for the following:

"Under the terms of the contract entered into by (1) the client corporation, (2) the selling stockholder, and (3) the buyer of his interest, the seller was paid $125,000 for 'additional values owned by seller but not reflected on the books of account of the corporation.' The buyer advanced this amount to the corporation to make the payment, and the corporation remains liable to repay the $125,000 to buyer when funds become available.

"How is this payment to be accounted for?

"This was a sale of a half interest in the corporation, and technically, all that has happened is that we have a new owner, and it cost us $125,000 to get him. As you may have guessed, relations between the former owners were somewhat strained, for a long period; attempts had been made in years past to find a buyer for the inactive owner's interest, without success until last year; this condition of conflict undoubtedly contributed to the company's losses; it is hoped that relations with the new half-owner will be more harmonious. On this basis, can the $125,000 payment be properly capitalized as Goodwill, to be amortized, perhaps, over a period of five or ten years? If there were sufficient surplus, I would suggest a charge direct thereto, considering it as a form of dividend, but with the capital accounts in their present state, I don't see how this can be done."

Our Initial Opinion

In our opinion, it is erroneous for the client corporation to reflect *any* liability to the new 50 per cent owner; and the corporation's balance sheet, as far as the effects of the transaction in question are concerned, should appear just as it would have appeared had the new 50 per cent owner paid the old 50 per cent owner $125,000 directly for his shares. We personally regard the language, "additional values owned by seller but not reflected on the books of account of the corporation," as so much surplusage, insofar as one might contend that it has any important bearing on substantive interpretation of the nature of the transaction which has taken place. Since the foregoing is premised in part on a conclusion as to legal effect, we believe the client or you may want to give serious consideration to obtaining an opinion of competent counsel on this point.

Our view of the transaction is as follows:

1. When $125,000 is "advanced" to client corporation, the latter may record a loan payable;
2. When $125,000 is disbursed to old 50 per cent stockholder, client corporation may record *treasury stock* in same amount;
3. When stock is transferred from old 50 per cent stockholder to new stockholder, the corporation should debit the loan payable account $125,000 and credit treasury stock in the same amount.

If, alternatively, the client corporation debited a loan receivable account when it disbursed $125,000 to the old 50 per cent stockholder, then, upon transfer of the shares on its books to the name of the new

50 per cent stockholder, it should cancel the loan receivable against the loan payable on the ground that, in effect, there has been a mutual release or discharge of all obligations between the three parties. Obviously, the client neither adds to nor detracts from its assets or obligations as a result of the "arrangement" in question; however, the old 50 per cent stockholder gets his "quid" (the money), and the new 50 per cent stockholder gets his "quo" (50 per cent of the client corporation's stock). On common sense grounds it is anomalous that the party acquiring the 50 per cent interest be paid back the consideration paid for said stock in the first instance, thereby ending up with 50 per cent of the corporation's stock without ever having paid anything for it. The usual case involving "purchase of a corporation or its stock with its own assets" results in the corporation's reflecting a *liability for future payments to the old stockholder — not a liability to the new stockholder.*

The major premise on which the foregoing is based is the overriding legal principle that a corporation may not *waste* its funds; that is to say, a corporation must generally expend its funds for consideration received and for a proper business purpose. Dividend distributions must be made to all stockholders pro rata. Thus, it appears that any distribution solely to the old 50 per cent stockholder would perforce have to be construed as a loan of money or as an acquisition of treasury stock (in the absence of other consideration being advanced to the corporation by the old stockholder who, incidentally, was not active in management). Similarly, it appears that the client corporation owes the new 50 per cent stockholder nothing *so long as* the money advanced or turned over to the client corporation was used to discharge either the latter's obligation or the new stockholder's obligation to the old 50 per cent stockholder for the stock received from the latter.

Quite apart from the "loan payable" and "treasury stock" or "loan receivable" interpretations of the transaction mentioned above, one might readily interpret the transaction as involving merely an *agency obligation* on the part of the client corporation to *pay over money* placed in its custody to the old stockholder. In other words, the money paid to the client corporation by the new 50 per cent stockholder would not be deemed an "advance" or "loan" but rather an entrusting of the money to the client corporation as disbursing agent.

Incidentally, in our opinion, there is no basis for construing this transaction as one involving a purchase of "Goodwill" by the corporation. Payment for Goodwill generally involves an explicit payment for a number of years' super-profits *of another company*. The fact that the corporation now has the good graces and amenability of a new 50 per cent stockholder who was instrumental in eliminating the "Badwill" of the old 50 per cent stockholder, provides no ground for the client corporation's recognizing Goodwill.

Follow-Up Inquiry

"I suspect from your reply that I failed to provide you with sufficient information, and therefore, am writing you again. Your references to treasury stock and loan receivable accounts lead me to believe that you were not aware from my letter that the $125,000 payment *was supplemental, and in addition to,* a payment of $94,000 made by the buyer of the stock direct to the seller, for his shares. The two clauses in the sale contract which are applicable read as follows:

> (Seller), as the owner of 390 shares, constituting ½ of the presently issued and outstanding shares of the capital stock of Corporation, agrees to sell to (Buyer) said shares for a purchase price of $94,000 cash and the additional consideration hereinafter specified.
>
> Corporation and (Buyer) agree to cause Corporation, or other entity, to pay to (Seller) the sum of $125,000, in cash, representing an agreed amount for the additional values owned by (Seller) but not reflected on the books of account of the Corporation. (Buyer) agrees to provide, or cause to be provided, by advance to Corporation or other entity (or otherwise), the funds necessary to make this payment.

"I am inclined to agree that the 'additional values' language is surplusage. The $125,000 cash was advanced to the corporation by the new 50 per cent owner, and it is the present intent of the parties that it will be repaid if and when funds become available. It was paid out immediately by the corporation to the old 50 per cent owner.

"It appears to me that a reasonable interpretation of this transaction might be that it has resulted in the creation of two classes of stock — the new owner's stock having a preference to $125,000 of dividends, after which all shares will again be equal.

"In support of the 'Goodwill' theory, it must be admitted that the transfer of ownership has been of material benefit to the corporation; the new owner has advanced substantial amounts on a long-term open-loan basis, and has guarantied inventory and other loans by banks. This financing would not have been available otherwise, and it was badly needed. The company had a large loss during the year just ended, but we are still hopeful for the future.

"The company has recorded the $125,000 as a liability to the new 50 per cent owner, and a debit to Goodwill. My audit is in process, and a final decision must be reached soon. No notes or other paper have been signed evidencing the liability for repayment of the $125,000, and it is my understanding that no agreement has been reached as to terms of repayment, or interest.

"I would appreciate your further consideration of this problem, and your advice as to whether you concur with my preference stock theory. I am sorry that I apparently failed to provide you with all of the information in my original letter."

Our Final Opinion

In reply to your further letter, we have the following comments respecting your client's situation, viz.:

1. Apparently there was no "donative intent" by the new stockholder – therefore, the $125,000 paid to the client corporation by the new stockholder may not be deemed contributed capital, i.e., donated surplus.

2. Accordingly, the "advance" (not supported by promissory note, i.e., unconditional promise to pay sum certain at fixed and determinable future time) must be viewed *either* as an *entrusting of the money* to the corporation as agent to pay over to old stockholder[1] *or* as a *loan of the money* by the third party.

3. If *loan*, then proper to reflect as loan payable on client's books. However, the money then becomes *corporate funds.*

4. Now, when the client corporation pays this money out, what *consideration* does the corporation receive in return? A corporation may legally disburse corporate funds only for a proper business purpose; and a corporation's disbursement of corporate funds to purchase its own stock is governed by statutory standards. *Either* the corporation receives a portion of the stock in question as treasury stock;[2] *or*

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[1] For what business or tax purpose?

[2] If all of the stock in question is in the custody of the third party, i.e., was transferred to it by the old stockholder upon payment of the $94,000, then the new stockholder holds 125/219 of the 390 shares of stock as "resulting trustee" for the client corporation.

from the standpoint of creditors it has "wasted corporate funds," or it has made a "preferential transfer" of assets, or an "illegal distribution"; *or* it has made a loan or advance to the old stockholder. If the latter, a loan receivable should be recorded.

5. If, then, the corporate client is deemed to have constructively received a portion of the stock in question, and thereafter, transferred same to "new stockholder," the *credit* to the treasury stock account to reflect said transfer should be offset by a *debit* to the loan payable (to third party) account. The third party then, according to this analysis, ends up as *either* a creditor *or* a stockholder, *but not both;* so long as it retains the full 390 shares *as owner thereof,* it cannot be a creditor, only a stockholder.

6. On the other hand, if the corporate client is deemed to have made a loan of corporate funds to the old stockholder, then any claim for payment of the $125,000 by new stockholder might be met by joining old stockholder in suit (assuming latter refused to pay back $125,000) and setting loan receivable off against the loan payable.

7. If the payment were deemed to be a "preferential transfer" or "illegal distribution," the amount *might* be recoverable by creditors from the old stockholder, but the latter *might* then sue new stockholder for recovery of the stock or a portion thereof.

8. Looking at it from the standpoint of yet another, alternative, assumption, if the client corporation were deemed to have received money as an agent to pay over, then upon paying out the money the agency account would be charged and eliminated. The new stockholder would have the stock, but there would be no corporate liability to the new stockholder. The receipt and later disbursement of the $125,000 would represent an "in-and-out" transaction as far as the client corporation is concerned. The client would have received no consideration or accretion to *its* assets warranting recognition of any liability to the third party.

9. If the client corporation is deemed to have engaged in a "capital transaction" (i.e., purchase of treasury stock), then there is no occasion for recording a purchase of "Goodwill." Furthermore, to record the Goodwill in the presence of operating losses and a deficit which exceeds the corporation's entire capitalization is a contradiction in terms. Moreover, you fully agree in your latest letter that the contract reference to "additional values owned by seller but not reflected on the books of account of the corporation" is so much surplusage.

10. The question raised in your latest letter, viz., whether the con-

tract and transaction in question may be construed as giving rise to two classes of stock is, of course, a legal question on which we are not in a position to express a definitive opinion. Perhaps we are permitted to say, however, that it appears highly unlikely any real support for this interpretation can be established in view of the considerations that the articles of incorporation have not previously authorized an issuance of preferred stock under such circumstances; that it would be stretching a point to conclude that the agreement for purchase and sale of the stock effectively amended the articles; that accordingly, the articles would have (or would have had) to be amended to create a new class of shares;[3] and that reversion of the shares from a preferred to a common stock status after the requisite preferential payment had been made would be most unusual.

11. Based on the "two clauses in the sale contract which are applicable" as set forth in your latest letter, our personal conclusion is that the "agency interpretation" is controlling. The first-quoted clause stipulates that 390 shares are the subject matter of the sale, that the then owner agrees to sell them to the buyer, and that the total consideration therefor is $94,000 plus the "additional consideration hereinafter specified" ($125,000), or a total of $219,000. In the second-quoted clause, the client corporation and buyer of the stock make mutual promises whereby (a) the latter will provide by advance to the client corporation the additional consideration for the stock which *said buyer in the prior clause has bound itself to purchase,* and (b) the client corporation undertakes to pay out to the seller of the stock the additional consideration as furnished. Can it be said that the corporation was anything more than an agent or temporary stakeholder in the premises? The cash transferred to the corporation was definitely *restricted as to its use,* and accordingly, we contend that it was, from its inception, *impressed with a trust* in the hands of the client corporation in favor of the old stockholder. According to this reading, the "Goodwill" on the corporate client's balance sheet should be written off against the "liability" account in question; and failing this, we believe the independent accountant should express an adverse opinion on the client corporation's statements.

12. The only *possibility,* as we see it, of retaining the liability on the client corporation's balance sheet would involve the following, viz.: (a) reclassification of the $125,000 of so-called "Goodwill" as

[3] See section 3638 of *California General Corporation Law.*

Treasury Stock; and (b) concurrent surrender to the corporate client by the new stockholder of some 223 shares (125/219 times 390 shs.) — such shares being the purported consideration received for the corporation's assumption of the liability in question. Thus, the third party would end up as part creditor and part stockholder. Whether the *remaining* stockholder would see fit to *donate* back to the corporation some 223 of his shares to restore a 50/50 ownership situation would be for him to decide. If this latter "scheme of things" were to be seriously contemplated, then, looking at it from the creditors' standpoint, perhaps the whole situation would be "sweetened up" a bit and rendered more palatable if the new stockholder were to explicitly subscribe to a subordination or standby agreement.

13. Regarding the *possible* solution put forth in the immediately preceding paragraph, a caveat should be expressed as to the legal implications. We believe it would be very useful to have the opinion of a competent attorney on the legal effects of the contract, *interpreted in the context, of course, of the client's present financial position.* It seems to us such determination would be quite pertinent to the independent accountant's expressing an opinion as to fair presentation.

Obviously, what concerns us here is the client corporation's (purported?) incurrence of a substantial liability to a new stockholder in connection with the purchase of its own shares at a time when its operating deficit exceeds its stated capital,[4] and when further increased by the "cost" of reacquired shares, substantially exceeds its stated capital. In considering this matter, it seems to us that sections 1704 through 1708 of the *California General Corporation Law* (especially the latter section) are critical (q.v.).

If the client corporation, because of its financial condition, may not legally purchase its own stock, query then whether it may legally assume any debt to the new stockholder in the circumstances of this case? (By our earlier line of reasoning, we took the position in effect that the reflection of treasury stock was a precondition to reflection of any debt to the new stockholder.) Also, if the contract clearly recites, and thus is interpreted to involve, the sale of 390 shares to the new stockholder, can it then be conveniently construed or reinterpreted to involve a sale by the old stockholder of some of his shares to the client

[4] Under the *Bankruptcy Act,* a person or entity is "insolvent" if the aggregate value of his (its) assets is not at a fair valuation sufficient to pay his (its) debts; "insolvency" in the State or equity sense of the term means inability to meet one's debts as they mature.

corporation and the remainder of his shares (a lesser number) to the new stockholder, especially in view of the financial circumstances?

Inquiry **422**

Treasury stock purchased with securities having market value in excess of their cost or carrying value

"The corporation for which I work has come up with an unusual accounting presentation problem and has asked my opinion on this matter. In referring to the textbooks, I can find no examples to cover the problem now confronting us. Would it be possible for you to recommend the proper entries to be shown on the corporation's books? The problem is as follows:

"Stockholder, now deceased, held over 50 per cent of the stock of one corporation. His estate qualified for the exchange of this stock for assets of the corporation as provided in Sec. 303 of the IRC covering redemption of stock. The executors of the estate have exchanged with the corporation sufficient stock to cover the payment of estate taxes and administration expenses. The asset given up by the corporation to the executors was in the form of a marketable security having a basis lower than its market value. The corporation received capital stock from the executors and intends to hold this stock as treasury stock.

"I would appreciate knowing whether the difference between the market value of the security given in exchange for the treasury stock over its cost basis should be credited to Capital Surplus and whether the basis of the treasury stock should be shown at the fair market value of the securities given in exchange for said treasury stock."

Our Opinion

This question is obviously a moot or debatable one. In our opinion, three possible treatments might be considered: (1) reflecting an accretion to capital, (2) recognizing a special gain or credit to income or earned surplus, and (3) recording the "cost" of the treasury stock at the historical cost or carrying value of the marketable securities transferred.

Not to stray too far from the immediate question, let us consider for the moment the following two passages from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), viz.:

> Property Acquired for Consideration Other Than Cash.— *Property Acquired in Trade.* — When property is acquired in exchange for other property, it is sound practice to record the acquired property at the carrying amount of the property disposed of, provided that such amount is reasonable and based on accepted accounting principles. Any cash required to equalize the exchange should be added to or deducted from the amount capitalized. If the asset disposed of is overstated or understated on the books by reason of inadequate or excessive allowances for depreciation, the recorded amount of the new asset should be adjusted accordingly. If the acquired property has been appraised recently or has a readily obtainable market value, this value may be a guide to the valuation to be recorded and to any profit or loss resulting from the exchange.
>
> *Property Acquired in Exchange for Company's Stock or Bonds.* — As a general rule, cost of property so acquired should be determined either by the fair market value of the consideration given or by the fair market value of the property acquired, whichever is the more clearly evident. When neither is readily determinable, the situation requires careful consideration. (pp. 244-5)
>
> *Dividends Paid in Property Other Than Cash.* — There are two alternatives as to the amount to be charged to surplus of the disbursing corporation upon payment of a dividend in property. One is that earned surplus be charged with the cost of the property to the disbursing corporation; the other, with the market value of the property at the date the dividend is declared, any difference between market value and cost being reflected as a charge or credit to income or earned surplus of the period. Generally, the first alternative is used, although problems arise under either treatment, and it is not always possible to determine a fair market value. Income tax considerations may have an important bearing on the accounting treatment selected.
>
> If dividends are paid in property having a readily determinable market value appreciably in excess of the amount at which the property is carried on the books and these dividends are charged to surplus at book amount, the amount of this difference should be clearly indicated in the current financial statements. This is particularly important when there is more than one class of stock and the property is being distributed to a class other than

> common stock. Preferred stock with a fixed dividend rate should not profit by receiving dividends in property the value of which exceeds the fixed rate. (pp. 404-05)

Regarding the first two paragraphs quoted above and their possible relevance from the standpoint of answering the specific question with which we are concerned: *query* whether the "non-cash transaction" or "property-for-property" rule is *fully as applicable* in the case of a company's reacquiring its own capital stock in exchange for marketable securities as *some* accountants may consider it to be in the cases of more conventional transactions, such as exchange of fixed assets for other fixed assets, or issuance of its own capital stock for fixed assets or securities? According to one brand of "logic," it appears that the answer should be "yes"; i.e., if the rule applies when a corporation *issues* its own stock, why shouldn't it apply when it *reacquires* its own stock? Application of the rule to the case at hand would result in recognition of an accretion to capital surplus or a special gain or credit to income or earned surplus, since the fair market value of the securities given up would be deemed the "more clearly evident" value involved in the exchange. The "accretion" or "gain," however, would be offset by an equal diminution of total net equity applicable to outstanding shares (since treasury stock would be deducted from the sum total of capital stock and surplus in the balance sheet at a "cost" measured by the market value of the securities given up).

Some accountants might not feel uneasy about carrying a "gain" to earned surplus in the case in question. They might rationalize the treatment on an "as if" basis, contending that one may properly account for the transaction "as if" the corporation had first disposed of the securities for cash and realized a tax-free profit or gain measured by the difference between carrying value and fair market value of the securities, and then used the gross proceeds to purchase the treasury stock. If, upon subsequent retirement, the treasury stock recorded on the basis of the fair market value of the securities given up were to be charged in its entirety against capital stock and capital surplus, the anomalous result would be that a "holding gain" (appreciation of the securities during the period held) had in effect been transferred *from* capital surplus *to* earned surplus.

Regarding the last two paragraphs from *Montgomery* quoted above, we have no quarrel, of course, with the disclosure requirement mentioned in the second of the two paragraphs. However, the second alternative described in the first of the two paragraphs (q.v.), seems to us to be somewhat ambivalent and redundant, *as an accounting treatment.* Ambivalent, because the securities have been consistently reflected or carried on one accounting basis and are now accounted for by reference to another accounting basis; redundant, because the charge to earned surplus for the dividend at market or fair value (to the extent of any difference between market value and cost) is undone, offset, or "washed out" by a correlative charge or credit to income or earned surplus of the period, in the amount of any difference between market value and cost. The "usefulness" of this treatment is not clear, except for its possible effect on the income account. In the final analysis, by such treatment, earned surplus ultimately absorbs no more and no less than the carrying value of the property or securities paid out as a dividend. The situation is somewhat analogous to a corporation's paying cash dividends to itself on treasury shares, i.e., charging earned surplus, reflecting dividend income, and transferring such income back to surplus.

This having been said, our own personal conclusion on the case in question is that the treasury stock should be recorded at the cost or carrying value of the marketable securities transferred. We base this on the grounds that accounting is anchored to cost; that any restriction on earned surplus resulting from the company's acquisition of treasury shares, should be measured by the recorded cost of the consideration paid; that it is non-violative of the accounting principle that treasury stock transactions "relate to the capital of the corporation and do not give rise to corporate profits and losses" [see chapter 1, par. 7, of *Accounting Research and Terminology Bulletins* (AICPA, 1961)]; and that any "gain" or "loss" to capital will be recorded in due course upon retirement or resale of the treasury shares. If the difference between cost and market value of the securities given up is significant or substantial, the rule of informative disclosure would require (even in a closely-held corporation, bearing in mind creditors) clear indication of the difference in a footnote to the statements.

Inquiry **423**

Distribution of appreciated property in partial redemption or acquisition of company's own stock

"Kindly advise me on the following accounting problem:

"A close corporation reduced its outstanding capital stock by 384 shares of a par value of $100 each and distributed to its stockholders real estate with a market value of $60,000 but which appeared in the books at the original cost of $1,000.

"I made the following entry:

Dr. Capital Stock	$38,400	
Cr. Real Estate		$ 1,000
Discount on Redemption of Common Stock		37,400

"Considering that the individual stockholders have to report the receipt of the real estate at its market value as a liquidating dividend received from the corporation, do you think that this transaction should have affected somehow the retained earnings of the corporation?"

Our Opinion

In our opinion, the tax treatment of the real estate in the hands of the stockholders, should not affect the accounting treatment on the books of the corporation. Whether from the corporation's standpoint the transaction in question is characterized as a distribution in partial liquidation, a partial redemption of outstanding capital stock, or the purchase of treasury stock followed by retirement, we believe the entry should be substantially as set forth in your letter, except that we are inclined to think the word "discount" (although technically correct in this context) would be unclear or somewhat ambiguous if used to describe such credit balance in a balance sheet. Perhaps the $37,400 credit could be factually described as "Excess of par value of capital stock redeemed over carrying value of real estate distributed" or "Paid-in surplus arising from partial redemption of outstanding capital stock."

Inquiry 424

Premium paid upon redemption of callable stock option certificates

"I would appreciate your giving me some help on a problem which I have not been able to solve to my satisfaction. The problem is with reference to callable stock option certificates.

"The problem is this: A corporation issues callable stock option certificates for which the purchaser pays a stated price. For convenience, let us say that the purchaser pays $4,000 for the option certificate. The terms of the certificate are such that if the certificate is redeemed by the company within various periods of time, they will pay a premium for the redemption. Let us say for purposes of this example that after a period of three years, the premium amounts to $500 for each certificate.

"If $100,000 worth of these certificates were issued, the sum would reflect the weight that would properly be given to the problem. My question is: Should this premium paid upon the redemption of a certificate be debited to paid-in surplus, or should it be set up in a separate account such as deficit from redemption of callable stock option certificates, or should it be handled in some other manner?

"The problem is different from anything I have encountered because the optionee usually has to pay an additional sum in order to acquire stock if the option were exercised. In the particular problem, the additional payment also resembles an interest item."

Our Opinion

Where an option holder pays for the right to purchase stock, from the option grantor's standpoint, the transaction is usually viewed as a capital transaction, a stage in a prospective financing operation. Amounts paid in on both stock subscriptions and options are "capital-in-process," so to speak. Accordingly, there appear to be reasonable grounds for treating a redemption premium paid in retiring a callable stock option certificate in much the same manner as a redemption premium paid in retiring preferred stock. However, as may be gathered from a perusal of pp. 21.37-8 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) and pp. 387-8 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), it is relatively unsettled whether a redemption premium on preferred stock should be charged to earned surplus, or to any available paid-in surplus, or only to certain types of paid-in surplus.

Although we do not quarrel with the viewpoint that the issuance of option certificates for a consideration is in the nature of a capital transaction in the first instance, and in ordinary course, nevertheless we are impressed by your statement that "in the particular problem, the additional payment also resembles an interest item." In fact, we believe once the corporation calls a certificate and becomes bound to pay the premium, such premium may realistically be viewed and treated as interest expense, an amount payable for the use of the optionee's money up to the time of redemption.

Inquiry 425

Notes issued to acquire treasury stock — "discount" arising upon subsequent satisfaction at less than face value

"I would appreciate your advice on the following situation:

1. A corporation repurchased all of its capital stock held by A and B at a premium. This repurchase constituted 50 per cent of the outstanding capital stock.
2. A cash down payment was made and interest-bearing notes were issued for the balance.
3. Approximately one year after this transaction, corporate notes held by A and B were sold to C who was not a stockholder.
4. After holding the notes for a short period of time, C offered the corporation a discount if paid prior to maturity.
5. The corporation accepted C's offer and borrowed the necessary funds from the bank to pay off the notes at the discounted amount.

"Please comment on the terminology and placement of the discount on the books and the financial statements of the corporation."

Our Opinion

In our opinion, there is no categorical answer to the question which you raise. As we see it, four logical but not equally acceptable, alternatives are available: one would account for the first two transactions essentially *as one* (i.e., cash down payment and issuance of notes in consideration of treasury stock *and* settlement of notes held by C for less than their face amount), and account for the third transaction (loan from bank) separately; another would account for the first transaction separately and for the last two transactions as one (i.e., as interrelated transactions); another would consider all three transactions to be an interrelated package stemming from or arising out of a capital transaction; still another would consider the three transactions to be just that, namely, three separate transactions to be accounted for separately.

Our own preference runs to either the first- or last-mentioned alternative. According to the first alternative, the "discount" should be credited to the Treasury Stock account on the ground that the treasury stock would then be reflected at its effective cost to the corporation. If the repurchased stock had been retired, then the "discount" should be credited to the account (Capital Surplus or Earned Surplus or both, as the case may be) used to absorb the premium. Interest accrued on the bank loan would be charged to profit and loss in the usual manner. The foregoing treatment views the transaction giving rise to the "discount" as one involving mutual modification of the notes' terms relating to date of payment and the sum payable, with consequent reduction of the ultimate consideration or purchase price paid or to be paid for the repurchased stock.

The second alternative or frame of reference (to which we personally attach little weight) views the combined transactions with C and with the bank essentially as a *refinancing* or *refunding* of the initial obligation. Thus, it has been suggested that the "discount" be deferred and then amortized or accumulated against the gross interest accrued on the bank loan, analogous to treatment of premium received upon issuance of bonds.

The third alternative (to which we personally attach little weight) would tie the two subsequent transactions to the initial capital transaction. Presumably, in accordance with this view, interest would be capitalized as part of the cost of the treasury stock and the "discount" credited thereagainst.

425 :INQUIRY

The fourth alternative which we believe is clearly supportable, would consider the down payment and the original face amount of the notes issued for the stock to be the cost of such repurchased stock, not subject to subsequent adjustment. Upon satisfaction and discharge of the notes held by C for less than face value, income would be recognized and shown as a special credit in the income account. An appropriate description of the item might be "Gain on liquidation of notes payable for less than face value." The bank loan and interest accrued thereon would be handled in the usual manner. Regarding recognition of the "discount" as income, the following definition of "revenue" appearing at pp. 243-4 of *Municipal Accounting and Auditing* (National Committee on Governmental Accounting, MFOA of the U.S. and Canada, Chicago, 1951) is relevant, viz.:

> Revenue – additions to assets which do not increase any liability, nor represent the recovery of an expenditure, and the *cancellation of liabilities without a corresponding increase in other liabilities or a decrease in assets* (*our emphasis*).

Inquiry **426**

A. Treasury stock — presentation from standpoint of Michigan Corporation Act
B. Use of terminology "net book value"

"I have a couple of questions about balance-sheet presentation:

"1. My first question is concerned with the proper presentation of treasury stock on the balance sheet of a Michigan corporation. The meaning of 'Capital' according to Michigan statutes appears to be restricted to the amount(s) at which issued shares are carried in the books of the corporation. The remainder in Shareholders' Equity is referred to as 'Surplus.' The entire cost of Treasury Stock, not merely the excess over par, appears to be required to be deducted from 'Surplus.' Section 10h of the *Michigan General Corporation Act* reads as follows:

> . . . any corporation which purchases its own capital stock shall keep its books and records and prepare its annual report to the

> state *and its annual report to its shareholders* in such manner as to indicate clearly the cumulative effect of such purchases, either by showing the *cost* of such respective purchases as a deduction from surplus or by classifying its surplus accounts in such manner as to show the amount of surplus applied to such purchases and which therefore shall not be available for dividends of any kind or for additional purchase of its own stock or for any other purpose.... (*emphasis added*)

"According to the 1960 edition of the AICPA's *Accounting Trends and Techniques,* the most common balance-sheet presentation of treasury stock is to show it as a deduction from the total of capital stock and surplus, and the second most common presentation is to show it as a deduction from issued stock of the same class. Only three corporations showed treasury stock as a deduction from retained earnings in 1959, a decrease from five in 1955 and eleven in 1950. It appears to us that the last presentation best conforms with Michigan statutes, that the second presentation is contrary to Michigan statutes, and that the most common presentation would require a footnote to the balance sheet to disclose the restriction on retained earnings. What balance-sheet presentation(s) would you recommend? If the corporation strongly preferred a deduction from issued capital stock in the amount of the par value of shares held in the treasury, what would you suggest?

"2. My other question is concerned with the most appropriate wording for the footnote disclosing the collateral given for a payable. *Accounting Terminology Bulletins No. 3* (AICPA, 1956) recommends

> ... that the use of the term *book value* in referring to amounts at which individual items are stated in books of account or in financial statements, be avoided, and that, instead, the basis of amounts intended to apply to individual items be described specifically and precisely.

Our difficulty lies in finding a substitute for 'net book value' that is as meaningful to our clients. Prior to this, our footnote might read as follows:

> A chattel mortgage on an automobile with a net book value of $2,573 at June 30, 1960 has been given as collateral for a note payable to the bank with a balance of $893 at balance-sheet date.

Substituting for 'with a net book value of,' such phrases as 'with a net carrying amount of' or 'carried at a net amount of' or even 'carried in the books of account at a net amount of,' doesn't seem as acceptable to our clients. What would you suggest?"

Our Opinion

1. Regarding your first questions dealing with presentation of treasury stock in conformity with requirements of the *Michigan General Corporation Act*, in our opinion, the conclusions which you draw at the end of the third paragraph of your letter are sound. We believe either the first or the last presentation mentioned in your letter would be acceptable under the circumstances, i.e., show the treasury stock *either* as a deduction from the total of capital stock and surplus with a footnote disclosing the restriction on retained earnings, *or* as a deduction from retained earnings. However, in view of the statutory provision, we personally are strongly in favor of applying the cost of the treasury stock as a direct reduction of earned surplus.[1]

If the corporation insisted on deducting the par value of the treasury shares from issued capital stock, we believe such presentation would be improper both from the standpoint of the express statutory requirements and from the standpoint of what is now the most commonly-encountered accounting presentation. Accordingly, in our opinion, the auditor should take an exception to such practice in his report. Concerning this so-called "constructive retirement" of treasury stock, the discussion at pp. 426-7 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) should be noted, viz.:

> Formerly it was not uncommon to show treasury stock "as if" it were retired; the par or stated amount of treasury stock was deducted from capital stock, and the appropriate surplus accounts were adjusted for the difference between cost and par or stated value. In most states, this procedure reflected the situation as it would have been if the legal steps necessary for retirement of treasury stock had actually been taken. Serious objections to this method are that it implies a future retirement which may not take place, and does not indicate the possible effect on surplus of the restrictions arising from acquisition of treasury stock; therefore, it is not now considered the best practice.

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[1] See the item entitled "Balance Sheet Presentation of Treasury Shares" which appeared in Carman G. Blough's column in the April, 1963 issue of *The Journal of Accountancy* at pp. 74-5.

2. Regarding your second question, with all due deference to *Accounting Terminology Bulletins No. 3,* we are inclined to consider the term "net book value," especially when used to refer to depreciable fixed assets, quite suitable. Not only is the term succinct, but also in the context within which you are using it, we believe it has a rather commonly-understood signification. Merely by way of suggesting language alternative to the several phrases mentioned in your letter, perhaps you would consider palatable, the phrase "with a net depreciated cost of," or "reflected in the accounts at a cost of $X net of accumulated depreciation."

Inquiry 427

Treatment of premiums paid upon reacquisition of common stock for retirement

"Advice is requested as to the treatment of premiums paid on the reacquisition for cancellation and retirement by a corporation of part of its common stock, both voting and non-voting. All classes of the company's stock have par values.

"Some years ago, the corporation issued preferred stock for cash at a price in excess of par. About the same time, it increased its two classes of common stock by sales for cash at prices also in excess of par. Subsequently, additional common stock of both classes was issued by stock dividend. As a result, the company now has a capital surplus account represented by the original issue premium on all of the preferred stock and part of each class of common stock.

"The premium to be paid on the two classes of common stock to be reacquired and canceled will exceed the total capital surplus, and the company would prefer to eliminate the entire capital surplus account, thus reducing the charge to earned surplus. We find no authority for this treatment.

"It is our opinion that the portion of the capital surplus due to the sale of preferred stock must be maintained as capital surplus and that the portions of the capital surplus attributable to sales of voting and non-voting common may be charged separately only with that amount which bears the same ratio to the premiums on each class of common stock, as the number of shares to be retired bears to the number of shares outstanding (unreduced by treasury stock presently owned and not to be retired) of each class of common immediately before the proposed reacquisition and retirement."

Our Opinion

In our opinion, the discussion and conclusions expressed at pp. 13-14 of *Accounting Research Bulletin No. 43* (AICPA, 1953) support the treatment proposed by your client, viz., charging the premium to capital surplus to the full extent thereof, thus reducing the charge to earned surplus. We refer particularly to par's 5, 7, and 10, viz.:

> Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, *such transactions relate to the capital of the corporation and do not give rise to corporate profits and losses. . . . your committee . . . does not believe that, as a broad general principle, such transactions should be reflected in earned surplus. . . .* (*our emphasis*)

(It is unfortunate that the committee did not specify the treatment to be accorded an excess of price paid over paid-in value of shares where no capital or paid-in surplus is reflected on the books.) Note that the committee refers broadly to "capital surplus" and does *not* limit same either to "capital surplus arising upon issuance of common shares" or to "the portion of capital surplus arising upon issuance of common shares applicable to the shares reacquired, and either cancelled or restored to an unissued status."

This having been said, it must also be stated that there is a considerable and respectable authority to the effect that retained earnings should be decreased to the extent that the excess of the cost of treasury shares over amount received therefor upon resale, or the extent to which a premium paid upon retirement, exceeds the pro rata portion of paid-in surplus applicable to the same class of shares and any available surplus paid in on an issue no longer outstanding.[1]

Briefly commenting on the rationale set forth in the *Handbook* (*op. cit.* in footnote 1) at the top of p. 21.38 in support of charging an excess of price paid for shares over their total paid-in value to retained earnings:

1. The "belief," premise or conclusion that the amount in question is "a special type of dividend, loss, or distribution" conflicts with the committee view previously cited that "such transactions relate to the capital of the corporation and do not give rise to corporate profits and losses . . . as a broad general principle, such transactions should (*not*) be reflected in earned surplus."

2. Regarding "the theory that the amount paid in on each type of shares should be preserved" and, accordingly, no part of a premium or excess should be written off "against paid-in capital accounts applicable to the remaining shares of the same type, or to any other accounts labeled paid-in 'surplus,'" it can be stated that the amount paid in on each type of shares is certainly not preserved in cases where capital or paid-in surplus is credited in connection with the issuance of a stock dividend upon capitalizaton of earned surplus in excess of the par or stated value of the dividend shares, or when expenses of stock issue are charged against paid-in surplus arising upon the issuance of stock, or when a deficit is written off against capital, paid-in, or reduction surplus. Also, use of the above-quoted language, "or to any other accounts labeled paid-in 'surplus'" is extreme; paid-in surplus on an issue no longer outstanding would neither measure nor preserve the amount paid in on that particular issue.

3. The statement is also made that "In this way paid-in capital for creditor protection can be distinguished from capital earned, and

[1] See the discussions of this topic in *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) pp. 387-90, 422-3; Finney and Miller's *Principles of Accounting — Intermediate* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958) pp. 151-6; and the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) pp. 21.35-8. Another good discussion appears in Paton's *Advanced Accounting* (Macmillan Co., N.Y., 1949) at pp. 533 *et seq.* The *New York Business Corporation Law* which became effective on September 1, 1963, provides that, in the absence of insolvency, a corporation may purchase or redeem its shares out of "surplus" at any time (sec. 513(a)). If treasury shares were acquired through the use of earned surplus, the directors may elect at the time of *resale* to restore to earned surplus all or any part of the consideration received from the sale of the shares but not more than the amount by which the earned surplus was reduced when the shares were acquired (sec. 517(a)(5)).

also claims to paid-in capital among the types of ownership shares can be more clearly disclosed." We submit that "paid-in capital for creditor protection" is usually (but not always) measured by the par or stated value of the shares in question, not by the amounts paid in on such shares. Also, the ownership groups holding shares ordinarily do not have any claims to paid-in capital as such, and amounts paid in do not necessarily or ordinarily measure the amounts to which ownership groups would be entitled in the event of either voluntary or involuntary liquidation. For example, preferred shareholders may have paid in $125 for each $100 par value share and in the event of involuntary liquidation, may be entitled to $105 per share with or without further participation and with or without dividend arrearages.

4. *Accounting Series Release No. 45* endorses the principle that "a proper distinction between capital and income" should be maintained and then proceeds to reflect in earned surplus, in part, the effects of a "capital transaction."

Inquiry **428**

Regarding presentation of redeemable, redeemed, and redeemed and retired, preferred stock

"We have noticed that there is no uniform terminology or treatment in published statements of public companies covering redeemable preferred shares.

"Some companies show the original number of shares authorized by charter or letters patent (as described in Canada) and below this the number issued and outstanding at date of balance sheet. Other companies show the number of shares authorized less shares redeemed in the section describing the shares, and if comparative balance sheets are published, the number redeemed during the year is clearly shown.

"Our attorney advises us that redeemed shares can be reissued to other stockholders unless they are canceled by supplementary letters patent.

"We also notice that some companies in the section describing issued shares show the number originally issued less the number redeemed.

"Would you be good enough to advise the best procedure for proper disclosure both from an accounting and legal point of view?"

Our Opinion

The several editions of *Accounting Trends and Techniques* (AICPA annual survey of 600 corporate annual reports), as well as the material at pp. 422-3 and 426-7 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), and at pp. 139-43 of Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Toronto, 1957), indicate fairly comprehensively the proper presentation of redeemable preferred shares and treasury shares (issued shares reacquired which have neither been retired by charter amendment, i.e., authorization canceled, nor restored by proper charter proceedings to the status of authorized but unissued shares).

We would only add that we deem it especially desirable to show the number of shares originally issued and the number of shares redeemed and retired in those cases where there is a mandatory requirement that the corporation redeem and retire a certain number or amount of outstanding shares each fiscal period or an amount of shares based on a specified percentage of earnings.

Note the last full paragraph on p. 423 of *Montgomery*, regarding current classification in the balance sheet of amounts of preferred stock which must be redeemed within the next fiscal year. Note also footnote 10 on p. 141 of *Hills* which states that the words "retirement" and "redemption" should not be equated. Thus, preferred shares redeemed, but neither retired nor restored to the status of authorized but unissued shares, are issued but not outstanding, shares.

Business Combinations, Separations, and Reorganizations

POOLING OF INTERESTS AND PURCHASES

429

Guide for analysis of some basic transactions

The following represents observations made or thoughts which occurred to the author in the course of his editing the correspondence contained in this section of the book. The result, we believe, is a brief but critical and rather fundamental framework which some may find helpful as a means of "keeping their eye on the ball" when analyzing factually complex transactions.

I. *Distributions*: absolute, unqualified, out-and-out reduction in net assets. Measurement of amount of distribution when not in cash but property may be problem: "fair value" or "book value." If distributed property is accounted for strictly in terms of its carrying value and full *disclosure* is made as to current fair value of such property, *should* there be any problem? N.B. The reduction of net assets (i.e., debit to an account in the capital section) may correlatively involve not only a credit to an asset account but a credit to a liability account. Note also that a stock dividend does not qualify as a "distribution" as defined, no severance or divestiture of corporate assets being involved.

II. (*a*) *Sales,* (*b*) *Purchases,* (*c*) *Exchanges*:

(a) reduction of asset accompanied by increase in another asset, i.e., cash or receivables, with any measurable difference between considerations involved resulting in net reduction or increase in net assets – generally, *no equivalence* between recorded consideration received and recorded consideration given up (unless break-even sale).

(b) acquisition of asset accompanied by reduction of asset or assumption of liability – generally characterized by an *equivalence* of recorded considerations.

(c) acquisition of asset accompanied by divestment of asset. "Exchange" basically connotates an equivalence of current fair values of considerations involved. However, it is frequently asserted that an exchange is characterized by an *ambivalence* of considerations on the ground that the book value of the property given up does not realistically measure its current fair value. Should financial considerations of the market place or bargaining table control the accounting measurement of an exchange transaction? Should the so-called non-cash transaction rule invariably be applied here so as to record the "more clearly evident" of the two disparate values, with possible recognition at this point of loss or gain (decrease or increase in net assets)? Or should the consideration received invariably be measured in terms of the carrying value of the property given up, with any potential loss or gain being recognized when it materializes upon ultimate sale or abandonment of the property acquired in the exchange? An "exchange" has dual aspects of a "purchase" *and* a "sale." It is generally accepted that gain may not be recognized on a purchase. Is it proper to give the "sale" aspect of an exchange a *priority,* i.e., greater weight than the "purchase" aspect – thereby making an exchange a revenue-recognizing event?

III. *Acquisitions by Donation or Gift*: addition to corporation's net assets without any direct or equivalent expenditure being made therefor. Principle of full accountability for all assets utilized in operations requires recording thereof. Gift may be unrestricted or restricted as to time or purposes of its use. Generally accepted that gift of property should be measured ("cost" for subsequent accounting purposes) by best estimate of its current fair value at date of donation. If taxable enterprise is involved, allowance or offset account should be set up to recognize non-future-tax-deductibility of such fair value. Canceled or "forgiven" indebtedness comes within this heading also. Depending on facts and circumstances, it may involve either an increase in net assets (conversion of debt to equity) or a reduction of debt with correlative scaling down of an asset.

IV. *Acquisitions by Issuance of Company's Own Stock*: absolute, unqualified, out-and-out *present* addition to corporation's net assets.* Measurement of amount of the increment when property, not cash, is received, is problem. Basic alternatives: (a) *"fair value" of stock issued, or of stock or assets acquired?* (i.e., value as determined by reference to established market; bona fide offers; court or agency's official determination; arbitration; by adverse party; by "interested" bankers, board members or company officers, or "expert" appraiser; or by "disinterested" appraisal); (b) *"book value" of stock or assets acquired?* (i.e., carrying value of stock or assets transferred as indicated on books of constituent to "pooling," investor, affiliate, or subsidiary company transferring same – such carrying value representing either *residual historical cost* resulting from consistent past application of generally accepted accounting principles, or an *amount other than cost* fairly(?) or arbitrarily(?) imputed to assets transferred or to assets underlying stock transferred). Regarding IV(a) and (b), consider carefully the implication of the fact that acquisition of property for a corporation's own stock involves no equivalent cost expenditure, no actual severance of corporate assets (as contrasted with a "purchase"). For what reason, if any, should the

* This assumes, of course, that the items acquired represent an *adequate and sufficient* consideration (legally) or qualify otherwise as bona fide assets (from the standpoint of accounting criteria), e.g., future service potential, assignability for value, etc. In this connection, consider, e.g., unproved patents; non-transferable dealer-distributor or manufacturer's representative contracts terminable on short-term notice of either party; executory contracts, etc.

useful residual costs of a combined or "pooled" business entity suddenly become *useless* costs for subsequent accounting purposes? The transaction in question is additive of assets and involves a *continuity* of beneficial interests, regardless of whether the party receiving the stock acquires 1 per cent or 99 per cent of the issuing company's stock. The market value of the stock issued either for stock or assets of the conjoined interest, presumably recognizes (a) values estimated as realizable upon eventual disposition and/or (b) Goodwill (capitalized prospective earnings). No actual expenditure has been made for the latter by the corporate entity. Query whether the intrusion of such *anticipated* realizations into the balance sheet should be sanctioned? Or should the acquired assets and the new equity interest be measured in terms of the historical cost to the conjoined interest, with any superior values entering into the exchange ratio being recognized as gains or increments to the acquiring entity's net assets only when and if they actually materialize in the ordinary course of business operations?

Inquiry 430

Methods of business acquisition or combination

"We are currently engaged in an audit relating to a proposed acquisition by our client of another company. The specific conditions of the proposed combination or acquisition are presently under discussion. For this reason, we request your review and comment as to the probable accounting and tax consequences attendant on the various methods of consummating the transaction. Accordingly, we present herewith our understanding of the possible methods and resultant accounting and tax treatment with regard to the pending acquisition. Our client is designated as Corporation A and the company to be acquired is designated as Corporation B.

"METHOD 1: Corporation A acquires the net assets of Corporation B in exchange for voting stock of Corporation A. Corporation B dissolves and distributes Corporation A voting stock to its shareholders. In this event a merger (pooling of interests) would result in which the basis of the assets acquired would remain as in the hands of Corporation B, assuming that Corporation B is substantial in relation to the size of Corporation A, the business and management of Corporation B are continued, and the equity interests of the owners of Corporation B are substantially maintained. This result may also be accomplished through a new successor corporation.

"For tax purposes this method would qualify as a Clause C reorganization (even if there were no continuation of former management), and accordingly, any net operating loss carryovers of Corporation B would be applied to Corporation A's (or its successor organized to effect the merger) earnings after date of acquisition.

"METHOD 2: Corporation A acquires all or substantially all of the stock of Corporation B in exchange for voting stock of Corporation A. Corporation A dissolves Corporation B, taking B's net assets and retiring its stock. Accounting-wise, this would also result in a "pooling of interests," assuming the same conditions as to relative size, continuity of management and equity interests of Corporation B as set forth in Method 1. This result may also be accomplished through a new successor corporation.

"The tax consequences of Method 2 would be that of a Clause B reorganization, followed by dissolution of the predecessor company or companies (subsidiaries). Accordingly, net operating loss carryovers of Corporation B may be applied to earnings of Corporation A or its successor, after date of acquisition. If Corporation B is not dissolved, the transaction results in the acquisition of a subsidiary (accounting- and tax-wise). Corporation A may elect to file a consolidated tax return including Corporation B, or Corporation B may file a separate return. In either case, the net operating loss carryover of Corporation B at date of acquisition may be applied only against its own earnings after date of acquisition.

"METHOD 3: Corporation A acquires all or substantially all of the stock of Corporation B for considerations other than its voting stock (cash and preferred stock in this case). This would result in the acquisition of a subsidiary both from the accounting and tax standpoints. The carrying values of the subsidiary's assets may be adjusted at consolidation, and in the event Corporation A's investment exceeds the adjusted basis of Corporation B's assets, the excess should be so classified on the consolidated balance sheet. Net operating loss carryovers of Corporation B at date of acquisition may be applied against its earnings after date of acquisition. If Corporation B were liquidated, its net operating loss carryovers would accrue to Corporation A.

"METHOD 4: Corporation A acquires the assets of Corporation B in exchange for considerations other than Corporation A's voting stock (e.g., cash and preferred stock). The results of this method would be an outright purchase, and accordingly, Corporation A would adjust the carrying values of Corporation B's assets. The resultant tax treatment would follow the accounting treatment. Net operating loss carryovers of Corporation B would not redound to Corporation A even though its business was continued by Corporation A."

Our Opinion

As a matter of Institute policy, we do not undertake to express opinions on the tax aspects of questions submitted.

However, regarding the accounting consequences flowing from each of the four proposed acquisition or combination methods, we agree with you that Methods 1 and 2 should be treated as a "pooling of interests" and that Methods 3 and 4 should be treated as "purchases," as defined and discussed in *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957).[1]

Inquiry 431

"Purchase" vs. "pooling"

"Our client, the X Company, proposes to purchase all of the outstanding stock of the Y Company (a closely-held corporation) for shares of the X Company having a par value of $20,000 and a market

[1] The following references deal generally with the accounting principles and procedures governing so-called non-cash transactions (property or stock acquired for property or stock), basket purchases (property acquired as part of a package), and the treatment of an excess of parent's investment cost over underlying net equity of subsidiary, viz.:

1. *Accounting Research Bulletin No. 43* (AICPA, 1953), chapter 5, pp. 38 and 40.
2. *A.R.B. No. 51, Consolidated Financial Statements* (AICPA, 1959), par's 7 and 8, pp. 43-4.
3. "Consolidated Statements," by P. F. Brundage [chapter 5 at p. 5 in *Contemporary Accounting* (AICPA, 1945)].
4. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 245-6 and 262.

value of $500,000. The X Company is a publicly-held corporation with a New York Stock Exchange listing and is subject to regulation by the Securities and Exchange Commission. The net assets of the Y Company are reflected on the books of Y in the aggregate amount of $400,000. It can be assumed that such net assets are not understated in value and, therefore, that the cost of acquiring all of the outstanding stock of Y Company, to the extent that such cost exceeds said net asset value, is attributable to the purchase of general goodwill. It can also be assumed that said goodwill has an indeterminable life, and certainly a life no shorter than the contemplated existence of the X Company.

"We are interested in your opinion as to whether the X Company is required to show the cost of acquisition of Y Company stock in its investment account at a lesser figure than $500,000, and, assuming the answer to be in the negative, whether the difference of $100,000, representing the excess of cost over book value, is required to be amortized by annual charges against the income or surplus of the X Company and, if so, over what period.

"We desire to be in absolute compliance with requirements of the Securities and Exchange Commission and the accounting principles set forth by the American Institute of Certified Public Accountants. Accordingly, we direct your attention to SEC Regulation S-X, Rule 4.05, published as *Accounting Series Release No. 69* on December 20, 1950. We also direct your attention to *Accounting Series Release No. 3* as well as *Accounting Series Release No. 39* under Regulation S-X. There is also material in point contained in chapter 5 of your *Accounting Research Bulletin No. 43* (1953)."

Our Opinion

In our opinion, the answer to your question "whether the X Company is required to show the cost of acquisition of Y Company stock in its investment account at a lesser figure than $500,000," is quite clear if a "purchase" is involved. Paragraph 8, p. 24, of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957) states that

> When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more

> clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

Thus, it is quite clear that if a "purchase" is involved and the acquiring corporation issues stock with a market value of $500,000 (based on the price of the stock as quoted on the New York Stock Exchange) for the stock received, that amount measures, and should be recorded as, the cost of the investment in Y Company.

On the other hand, if the situation described in your letter is construed as a "pooling of interests," then in our opinion, it is not clear at the present time at what figure the investment should be recorded. In this connection, note carefully par. 9, p. 24, of *A.R.B. No. 48.* See also the item "Long-Range Commitments in Handling New Subsidiaries" which appeared in Carman G. Blough's column at pp. 71-2 of the September, 1957 issue of *The Journal of Accountancy.* Note especially the statement at p. 72, viz.: "As we understand *A.R.B. No. 48*, the fair market value of the stock issued by Corporation X in exchange for the stock of Corporation Y would be *irrelevant* in accounting for the exchange if a 'pooling of interests' rather than a 'purchase' is in fact involved. . . . Accordingly, if a 'pooling of interests' is deemed to be involved, we believe Corporation X should carry its investment in Corporation Y at $50,000," i.e., at the par value of the shares received (*our emphasis*). Further, regarding your question whether the X Company is required to reflect its investment in Y Company stock at a lesser figure than $500,000, we believe some accountants would contend (on the basis of the first two sentences of par. 9 in *A.R.B. No. 48*) that the X Company's investment in Y Company's stock *may not exceed* Y Company's net assets, i.e., $400,000.

However, some accountants would contend that failure to record the capital and investment accounts of the parent in terms of the fair value of the consideration paid or received, whichever is more clearly evident, results in a departure from the cost basis, and an understatement of both assets and capital.

Note also that Ralph J. Baker in his article "Dividends of Combined Corporations: Some Problems Under Accounting Research Bulletin No. 48" (72 *Harvard Law Review* 494 at p. 496, January, 1959) refers to the third sentence of par. 9 of *A.R.B. No. 48* and states: "Such adjustments would include writing up or down the subsidiary's assets if the price paid for the shares of the subsidiary exceeds or is less than the book amount of its net assets."[1] We believe this latter conclusion is an erroneous inference as to what the Institute's Committee on Accounting Procedure had in mind by the *Bulletin* passage in question. It goes without saying, the ambiguity of the passage leaves itself open to such interpretation. It is our understanding "adjustments" has reference to over- or under-accruals of depreciation, amortization, allowances, estimated liabilities, etc.

Regarding the question whether the $100,000 difference (excess of fair market value of stock issued over book value of stock acquired) is required to be amortized, etc., we suggest perusal of reference "4c."

N.B. Subsequent to the above exchange of correspondence, *Accounting Research Study No. 5, A Critical Study of Accounting for Business Combinations,* by Arthur R. Wyatt (AICPA, 1963), was published.

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[1] Several other references from among scores of articles dealing with the "pooling" concept, are:

1a. "Accounting Problems Arising in the Acquisition of Other Businesses"
b. "Case Studies of Accounting Problems in Business Combinations"
(Above articles appeared in the June and September, 1957 issues, respectively, of the *News Bulletin* of the Massachusetts Society of CPAs, at pp. 133-4, 138-41 and 2-4, 11-13.)

2. "Business Combinations: Purchase vs. Pooling" (in L. H. Rappaport's column "Accounting at the SEC" at pp. 745-6 of the October, 1958 issue of *The N.Y. CPA*).

3. "Accounting Aspects of Business Combinations," by A. Barr, given before the August 27, 1958 meeting of the American Accounting Association at Syracuse University — Mr. Barr's paper dealt with the SEC's position on business combinations (*The Accounting Review*, April 1959, pp. 175-8).

4a. "Business Combinations," by AICPA Research Department (pp. 51-3)
b. "Business Combinations: An Alternate View," by George O. May (pp. 33-6)
c. "Intangibles in Business Combinations," by William W. Werntz (pp. 46-50)
d. "Business Combination: 'Pooling or Purchase' " (pp. 55-6)
(Above items appeared in the February, April, May, and July, 1957 issues, respectively, of *The Journal of Accountancy.*)

5. "Business Combinations," by W. J. Schrader (in *The Accounting Review* for January, 1958, pp. 72-5).

Inquiry **432**

Upstream or downstream merger? Treatment as purchase or pooling? Is upward restatement justified?

"It will be much appreciated if you will advise the proper way for handling the mergers described below.

"The boards of directors of Corporation A and Corporation B are discussing the possibilities of a merger, at a time when their respective balance sheets appear as follows:

CORPORATION A

Inventories	$80,000	Current Liabilities	$100,000
Other Current Assets	80,000	Long-Term Liabilities	300,000
Land	60,000	Preferred Stock—$10.00 Par Value (Non-Participating, Non-Cumulative, Non-Voting, Entitled to 6% in a Given Year Before Any Payment Made to Common, and to $10.50 per Share in Liquidation)	30,000
Other Fixed Assets	200,000	Common Stock ($2.50 Par Value)	55,000
		Capital Paid In in Excess of Par Value of Common Shares Issued for Cash	112,500
		Earnings Retained in the Business (Deficit)	(177,500)
	$420,000		$420,000

CORPORATION B

Current Assets	$100,000	Current Liabilities	$100,000
Fixed Assets	55,000	Preferred Stock ($10.00 Par Value, Non-Cumulative, Non-Participating)	19,000
		Common Stock ($10.00 Par Value)	30,000
		Earnings Retained in the Business	6,000
	$155,000		$155,000

"During the negotiations, it is agreed that the following adjustments will be considered for purposes of the exchange of shares of stock:

Corporation A's Assets:

Lifo inventories carried at $80,000 will be considered at fair market value which exceeds Lifo cost by $200,000.

Land carried at $60,000 will be considered at fair market value which exceeds book value by $160,000.

Other fixed assets carried at $200,000 will be considered at replacement cost less accumulated depreciation, which exceeds cost by $250,000.

Corporation B's Assets:

Fixed assets fully depreciated, or written off upon acquisition to be considered at replacement cost less accumulated depreciation, which exceeds cost by $15,000.

Thus, the adjusted equity of stockholders of Corporation A amounted to $630,000 and that of stockholders of Corporation B amounted to $70,000, or one-ninth that of the stockholders of Corporation A.

"If Corporation A is merged into Corporation B, Corporation B issuing 52,500 shares of common stock in exchange for all of the outstanding stock of Corporation A, which of the adjustments for asset values considered in arriving at the rate of exchange should be recorded on the books of B Corporation and included in future financial statements? In the event Corporation B is merged into Corporation A, Corporation A issuing 2,566 shares of common stock in exchange for all of the outstanding stock of Corporation B, will there be any difference in the adjusted values for assets as compared with a merger of Corporation A into Corporation B?

"The accounting treatment permitted may have an important bearing upon the plan of merger adopted."

Our Initial Opinion

In our opinion, an initial question to be considered is whether the contemplated merger or business combination is a "purchase" or a "pooling of interests" as broadly defined by *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957). In this connection, note especially the following statement in par. 6:

...Thus, if the management of one of the constituents is elimi-

> nated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated. Relative size of the constituents may not necessarily be determinative, especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 per cent to 95 per cent or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.

In the case described in your letter, we note that the adjusted net equity of Corporation B as agreed upon during negotiations, is one-ninth of the adjusted net equity of Corporation A, or 10 per cent of combined adjusted net equity. Based on the agreed upon *values,* we have been unable to determine how the respective *numbers* of shares (52,500 shs and 2,566 shs) to be issued by Corporation B or Corporation A, depending on which corporation is merged into the other, were determined. Using the respective numbers of shares cited, if Corporation A were merged into B, the older stockholding group of B would end up after the merger with 5.4 per cent of the total outstanding common shares of the continuing corporation. On the other hand, it appears that if Corporation B were merged into A, the old stockholding group of B would end up after the merger with 10.4 per cent of the total outstanding common shares of the continuing corporation. Paragraph 6 of *Accounting Research Bulletin No. 48* states, in part: ". . . where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 per cent to 95 per cent or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests." In view of the foregoing and the fact that the situation in question is obviously a borderline case, we do not believe it would be unwarranted to construe the transaction as a "purchase," whichever direction the merger takes. Let us proceed on the premise of a "purchase" and see where we come out.

You will note that paragraph 8 of *A.R.B. No. 48,* states the general principle which applies in accounting for "purchases," especially in the case of so-called non-cash transactions (e.g., exchange of stock for stock).

A crucial question here, however, has to do with the reasonableness of the values ascribed to the assets in the negotiations, and the independent accountant's responsibility in forfending against watered capital in statements to which he lends his name. Prima facie, we would be inclined to question the values imputed to Corporation A's assets. Of course, we are not aware of certain important background information, viz., *who* determined the values, *how* the values were determined, whether the negotiations were completely at arms-length, and whether the same values would have been ascribed to the assets if the consideration for the exchange of the shares of the other company had been cash, or stock having a ready market and publicly-quoted price. We also give considerable weight to the fact that Corporation A's capital is impaired by what appears to be a $177,500 operating deficit.

Assuming as we must for purposes of further discussion of the specific questions raised in your letter, that the values determined in the negotiations are realistic and not whimsical or arbitrary, then in our opinion, the accounting procedures should be such that essentially the same combined financial position should be reflected in the balance sheet *whichever direction the merger goes.*

To elaborate somewhat, if A is merged into B, the latter would initially record its investment in A at the fair value of A's stock (let us say, at $630,000, the adjusted net assets of A). Upon subsequent liquidation of A, Corporation B's investment should be credited $630,000 and the net assets of A taken over and recorded at $430,000, the respective appraisal increments attributable to land, and other fixed assets being allocated to such accounts, and the $200,000 appraisal increment attributable to Lifo inventories being charged against Corporation B's paid-in surplus to the extent thereof ($105,000) and the remainder charged to a reduction surplus created by reducing the par value of B's stock rather than making the charge to other surplus accounts and/or stock discount. Corporation A's deficit would disappear in the process, and no appraisal surplus would be reflected on continuing Corporation B's books except to the extent that Corporation B may have written its pre-merger fixed assets up to replacement cost less depreciation applicable thereto. Presumably, the total net assets of the continuing Corporation B would then be reflected at some $500,000.

Incidentally, if at the outset Corporation B recorded its investment in the stock of A at $430,000 (disregarding the appraisal increment attributed to the Lifo inventories in the negotiations) and issued 52,500 shares of its common stock without reducing the $10 par value thereof, then it appears Corporation B would have to record stock discount in the amount of $95,000, even though the fair value attributed to the property acquired exceeds the par value of the stock issued.

It seems to us the foregoing procedure (merger of A into B) points up several loopholes in presently existing requirements respecting fair presentation and disclosure. Here, Corporation A's substantial deficit and substantial appraisal surplus disappear into thin air! If dating of surplus upon elimination of a deficit pursuant to an accounting quasi-reorganization is required, is the requirement any less necessary in a case where a deficit is eliminated pursuant to a legal reorganization (i.e., merger)? Should one be able to accomplish indirectly what one may not accomplish directly? What designation is to be given to the carrying basis of the assets in the statements of continuing Corporation B? Cost? Or Cost plus Appraisal Value? Should the *amount* of the appraisal increment be disclosed, or is the CPA now free to omit this disclosure? How is the difference between book and tax depreciation to be explained in future statements? Is the $410,000 appraisal increment of A which is now reflected on the books of B without indication as to its nature or origin, as well as the $15,000 appraisal surplus reflected on B's books, properly to be reduced by an allowance for the taxes attributable thereto [some $172,500 ($265,000 @ 50 per cent; $160,000 @ 25 per cent) due to future non-tax-deductibility of appraisal increment]? We are not aware of any explicit guideline in the accounting and auditing literature respecting this specific type of situation.

On the other hand, if B is merged into A, the latter would record its investment in B at the fair value of B's stock (let us say, at $70,000, the adjusted net assets of B), and upon subsequent liquidation of B, net assets of $70,000 would be taken over and recorded on A's books. Then, if no further adjustments were made on continuing Corporation A's books, the $177,500 deficit would still be reflected, and its net assets would amount to only $90,000, a considerably different result from that obtained when A is merged into B. Accordingly, if we assume that the values determined in the negotiations are realistic, and if, as stated earlier, the accounting procedures should achieve essentially the same combined financial position *whichever direction the merger goes*, then it follows that Corporation A would have to write up its land and other fixed asset accounts $160,000 and $250,000 respectively, and credit revaluation surplus $410,000. Furthermore, if

Corporation A then contemplates writing off its $177,500 deficit, we believe the requirement of an *accounting quasi-reorganization* that the earned surplus account thenceforth be dated, should apply. In this connection, we note that coincidentally, the paid-in surplus of continuing Corporation A approximates the amount of the deficit. However, according to our figures, A's paid-in surplus would amount to $176,085 (i.e., $112,500 plus $63,585 arising upon issuance of 2,566 shares to the B stockholders) and thus, would not be able to absorb the deficit to the extent of $1,415.

Incidentally, it goes without saying, if appraisal values are introduced into the accounts of either corporation, the appreciation (i.e., the portion of the increment attributable to depreciable or amortizable assets) is subject to depreciation for financial statement purposes.

This leads to a further point involving tax allocation. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 500) states the following:

> Income Tax on Appreciation of Fixed Assets. — The rule has previously been stated that when fixed assets are written up to appraised amounts, depreciation based on the written-up amounts should be charged to income. For federal income tax purposes, however, depreciation may be based only on cost. Fixed assets on which depreciation is not fully deductible are less valuable to a company than are identical fixed assets on which depreciation is fully deductible. If recorded in the accounts, an excess of appraisal amount over cost should be reduced, either directly or by means of an allowance, by the estimated reduction in income taxes that would result in future periods if depreciation on such excess were deductible for federal income tax purposes.

Thus, the appraisal increment attributable to depreciable assets should be "discounted" to the extent that taxes will be higher in future years due to the fact that such appraisal increment is not tax deductible. If the one-shot adjustment indicated as being required by *Montgomery* is made, the debit corresponding to the direct credit to the fixed asset account or to the allowance, should be made to appraisal surplus. If the appraisal amount is not reduced at the outset by the tax adjustment, either the tax provision or the depreciation on appreciation in future income statements would have to be reduced by the amount that taxes are higher due to non-deductibility for tax purposes of the depreciation on appreciation. The corresponding charge would be to appraisal surplus. Incidentally, in the case of non-depreciable assets such as land or securities which are written up to a fair market value in excess of cost, the question is moot whether the gross appraisal increment should be reduced by the capital gains tax which would be payable upon liquidation of such assets.

Follow-Up Letter from Same Correspondent

"Many thanks for your very helpful and informative reply to my involved inquiry. It is already proving quite useful.

"From your letter and the other information I have seen on the subject, I assume that if the transaction involving the combination of the two businesses described represents a 'pooling of interests,' the asset carrying values, surplus, etc., on the combined corporation's books and statements will be the same as the total of the corresponding amounts on the separate books and statements of the respective corporations. On the other hand, if the transaction represents a 'purchase,' and you feel that such interpretation may not be unwarranted per par. 6 of *A.R.B. No. 48,* then adjustment of values will be necessary (or at least permissible and proper).

"Actually, the exchanges have been completed since I wrote you last – one corporation giving 15-year subordinated term notes for the preferred stock of the other, and giving common stock for common stock on the basis of the adjusted book values applicable to each corporation's common stock after giving effect to the agreed revaluations.

"This brings me back to certain points raised by you in your letter. You question the reasonableness of the values ascribed to the assets and indicate the accountant needs to know who determined the values, and how the values were determined, whether the negotiations were at arms-length, and whether the same values would have been ascribed to the assets if the consideration for the exchange of the shares of the other company had been cash, or stock having a ready market and publicly-quoted price. You also note that Company A's capital is impaired by an operating deficit.

"The two corporations involved were formed within the last four years or so. Corporation A, the larger one and the one with the large writeup, was spun off by a very old corporation which transferred real estate to the new corporation at cost to it (the real estate had been held more than one hundred years). In addition, various items of inventory, machinery, etc., were sold to the new corporation at 80 per cent of the book value carried by the old corporation (items fully depreciated, or not on the books at all, went over without any payment). These facts, I think, make it entirely possible that the valuations are reasonable, which, of course, is not enough.

"It is my clear understanding the negotiations were at arms-length.

Since both corporations were in similar businesses, the officials and stockholders (or at least some of them) of each corporation were entirely familiar with the types of machinery, etc., possessed by the other, and both had been buying (and still were buying) similar equipment, both new and used. It is probably true that neither of the corporations considered a cash purchase inasmuch as neither of the corporations was in a suitable position to make a cash purchase. The larger corporation was represented throughout the negotiations by its board of five directors; the smaller corporation by its two principal officers. The larger corporation has about two hundred stockholders, the smaller, about fifteen. I think it would be fair to say that the values used (other than those obtainable from the books) were determined by the directors of the two corporations after careful inspections, lengthy discussions and observations over a period of several months. Within the past eighteen months the larger corporation has raised approximately $400,000 of capital through private sales of common stock (coupled with a purchase of term notes) at approximately the same price arrived at for this exchange, sales being made to about forty different subscribers. The larger corporation has been in the process of constructing a plant, only a small part of which was in operation prior to the date of the exchange here involved. This, in large part, accounts for the accumulated deficit to date. As far as I know, no outside appraisal has ever been made of any of the properties involved, all of the values being based upon knowledge of the parties of prices, etc., of similar properties.

"Do you believe the foregoing is adequate basis for entering the assets at the upward revised values? If not, can you offer further suggestions?"

Our Final Opinion

Although many would perhaps conclude, on the basis of the foregoing, that the upward restatement of asset values is "reasonable," we personally feel that the occasions where upward restatement of book values is warranted, are rare indeed. Almost invariably, upward revisions have a self-serving purpose, and are violative of both the cost and realization principles.

In the case in question, we have a small corporation organized only four years ago with only $6,000 of retained earnings, and a large spun-off corporation in process of constructing a plant, and with a substantial deficit of $177,500 – a deficit which if not accumulated within the four years since it was spun off, must then represent the portion of the old-line company's deficit which was allocated to Corporation A when it was spun off. Ordinarily, it would appear that a writeup in the presence of deficit operations is a contradiction in terms.

Most writeups are rationalized on the basis of a projection of superprofits, but generally there would be some profit history to support such a projection. In any event, the appraisal surplus recorded as a result of such projection is, from an accounting standpoint, an unrealized increment. Should we be prepared to accept the view that it is sound to reflect substantial additional capital based on projected profits, although unsound to reflect anticipated profits in the statement of operations?

In the absence of any profit performance as in the case in question, may we still resort to directors' valuations for land and machinery based on "careful inspections, lengthy discussions and observations over a period of several months"? May we base a writeup of the assets on the private sales of common stock during the past eighteen months "at approximately the same price arrived at for this exchange"? What representations were made to the subscribers of such stock, and what were the bases of such representations?

How will the $425,000 total writeup be realized by the stockholders? The $125,000 increment to land is subject to tax upon disposal, but if the land is to be used as the site of the new plant, its disposal seems remote unless the business itself is to be sold. The $265,000 increment to depreciable fixed assets is non-tax-deductible, and moreover, represents future cumulative depreciation on appreciation which, when charged to future years' operations, will never lodge in earned surplus in the case of the merger of A into B (because the appraisal surplus has been transmuted into "permanent capital"), and will lodge in earned surplus in the case of the merger of B into A only if transfer is made from appraisal surplus to earned surplus.

Query whether the non-cash-transaction rule applying to "purchases" should apply in cases where a corporation's own stock represents one of the considerations exchanged? Query whether the 90 per cent or 95 per cent criterion is necessary in defining a "pooling"? In the situation in question as with any true merger situation, there is as much a "flowing together" or corporate fusion of A and B as in any other case involving exchange of one corporation's stock for the stock of another corporation.

If a pooling were effected in the present situation, Corporation A would have some $91,415 of capital stock; and $155,085 of paid-in surplus. The latter, after creation of a reduction surplus of $16,415, could be used to absorb a writeoff of a net deficit of $171,500. The continuing Corporation A would then make a "fresh start" with a dated surplus and stated capital of $75,000.

Inquiry **433**

Distinguishing the accounting effects of a "purchase" and a "pooling of interests"

"In reading the article 'Management's Choice to Purchase or Pool,' by Henry R. Jaenicke, in the October, 1962 issue of *The Accounting Review,* I got the impression that the 'pooling accounting' resulted in a lower goodwill figure than the 'purchase accounting' treatment calculation for goodwill in a consolidated statement.

"References in this article are 'Mergers Create Financial Magic,' *The New York Times,* April 30, 1961; Samuel R. Sapienza, 'Distinguishing Between Purchase and Pooling,' *The Journal of Accountancy,* June, 1961.

"I would greatly appreciate any information you can furnish that would clearly illustrate the authority and the advantage of using 'pooling accounting,' explaining how the use of this pooling method can result in a lower goodwill figure."

Our Opinion

You ask for "any information . . . that would clearly illustrate the authority and the advantage of using 'pooling accounting.'" We personally think the Jaenicke article, "Management's Choice to Purchase or Pool" (*The Accounting Review* for October, 1962) did an effective job not only in indicating the more favorable *income* results that are reflected when a business combination or acquisition is treated as a "pooling of interests" in situations where the fair value of stock issued by the acquiring company substantially exceeds the book value of the stock or net assets of the acquired company, but also in indicating the more favorable *income* results that flow from treatment of an acquisition as a "purchase" in so-called bargain-purchase situations, i.e., where the book value of the stock or net assets of the acquired company substantially exceeds the consideration (usually cash or substantially cash) paid by the acquiring company. The Jaenicke article summarizes the accounting factors and considerations involved at pp. 762-3 thereof (q.v.).

Whether the article in question, however "effective," is an entirely *creditable* one, remains to be judged. We personally believe the suggestion that "pooling accounting" is some sort of Machiavellian maneuver is rather overdrawn — especially when it is recognized that pooling accounting *effectively continues to anchor the net assets taken over to the acquired constituent's cost* and eschews any resort to stock market share prices (which reflect the capitalization of *future* profits) in accounting for the acquiring company's issuance of its own shares. And what better or more conservative way is there for a company to recognize the gain inherent in an alleged "bargain purchase" than to recognize it piecemeal when, as, and if subsequent profits actually accrue?

We note further that Mr. Jaenicke (p. 762 of his article) makes the following statement, viz.:

> The eclipse of *Accounting Research Bulletin No. 48* (AICPA, 1957) has removed all important obstacles to the use of pooling-of-interests accounting where the major part of the consideration given has been stock. The second factor adding to management's freedom in this area is the generally accepted view that the pooling concept is not at all mandatory even in those cases where the criteria have obviously been fulfilled, but is as yet completely permissive in its application under such circumstances.

It is a gross exaggeration, to say the least, to refer to the "eclipse" of *A.R.B. No. 48* by pointing to a relatively few "less than 5 per cent" cases where the use of pooling accounting has been *extended* rather than curbed! How this adds up to an "eclipse" for a bulletin which *sponsored* pooling accounting in appropriate circumstances, is not quite clear.

As for the contention that "the pooling concept is not at all mandatory even . . . where the criteria have obviously been fulfilled, but is as yet completely permissive in its application . . ."—we are at a complete loss to know the genesis of this conclusion.[1] As far as the Institute's official position is concerned as set forth in *A.R.B. No. 48,* it is indisputably clear that *mandatory* rather than permissive language is used both in the opening paragraph and in the two key paragraphs (i.e., 8 and 9) of the *Bulletin.* Thus:

> Whenever two or more corporations are brought together, or combined, for the purpose of carrying on the previously conducted businesses, the accounting to give effect to the combination *will vary* depending largely upon ... etc. (par. 1, *our emphasis*)
>
> When a combination is deemed to be a purchase, the assets acquired *should be recorded* on the books of the acquiring corporation at cost, measured in money, or, . . . at the fair value of such other consideration, . . . etc. (par. 8, *our emphasis*)
>
> When a combination is deemed to be a pooling of interests, *a new basis of accountability does not arise.* The carrying amounts of the assets of the constituent corporations . . . *should be carried forward;* and the combined earned surpluses and deficits, if any... *should be carried* forward ... etc. (par. 9, *our emphasis*) q.e.d.

One observation that should be made is that treatment as a pooling in the first type of situation, and treatment as a purchase in the second type of situation, mentioned in the first paragraph of this reply, bring about a more favorable portrayal of *operating results* but a less favorable portrayal of *asset values.*

Of course, one basic point to understand is that to have the *possibility* of treating an acquisition as a "pooling," the acquiring company must issue stock to acquire stock or net assets of the acquired or combined company. The purchase situations generally involve the payment of cash by the acquiring corporation. However, issuance of stock for stock or net assets, does not, in some situations, preclude treatment as a purchase; we have principal reference here to the "less than 5 per cent" situations (see par. 6 of *A.R.B. No. 48*) where, according to the letter of the *Bulletin,* there is a presumption that a "purchase" is involved.

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[1] Leonard Spacek, at p. 38 of his article "The Treatment of Goodwill in the Corporate Balance Sheet" (in *The Journal of Accountancy* for February, 1964) also *asserts* the following: "The pooling concept, while achieving the desirable result of avoiding the incongruities of the methods used in accounting for goodwill, has not solved the problem but rather has compounded it. First, it has merely added one more alternative, since pooling is permissive and not mandatory."

Certain relevant pages in *Accounting Research and Terminology Bulletins* (AICPA, 1961 – namely, pp. 38 and 40, chapter 5; pp. 24-5 of *A.R.B. No. 48;* pp. 43-4 of *A.R.B. 51*) may be helpful to you in indicating the rules generally governing the accounting for non-cash transactions and purchases and the requirements respecting allocation of the excess of any consideration paid over book value of stock or net assets acquired, to tangibles or intangibles, as appropriate. We believe a proper understanding of the foregoing rules is basic to an understanding of how "use of this pooling method can result in a lower goodwill figure."

Perhaps the following example of what is involved may serve to clarify these situations:

Assume Company A issues 1,000 shares of its stock ($10 p.v., $150 per share *publicly-traded* market value) having an aggregate market value of $150,000 for the net assets of closely-held Company B having a book value of $90,000 (net worth of B comprises $30,000 capital stock outstanding and $60,000 of earned surplus).

If this transaction *were* to be treated as a purchase, Company A must then use the $150,000 market value of its stock to measure the cost of the net assets acquired since a non-cash transaction is involved and this is the "more clearly evident" value. Accordingly, in recording the net assets on its books, Company A must allocate a $60,000 excess, i.e., the difference between the carrying value of the net assets on the selling corporation's books ($90,000) and the market value of the consideration exchanged therefor ($150,000), to the tangible and/or intangible (Goodwill or other) assets taken over. Such allocated excess would then be depreciated and/or amortized and thus reflected as charges in future income statements. Incidentally, in recording the net assets as $150,000, correlative credits of $10,000 to capital stock and $140,000 to paid-in surplus accounts, would be made.

However, if Company A does not follow the rule governing non-cash transactions and "purchases," but rather treats this as a "pooling" on grounds that the operative facts of the transaction meet the *Bulletin's* criteria of a pooling, then it would record the net assets taken over at $90,000 (carrying value on the books of Company B) and would make correlative credits of $10,000, $20,000, and $60,000 to its capital stock outstanding, paid-in surplus, and earned surplus accounts, respectively. Thus, with this pooling treatment, Company B's earned surplus would be carried forward, and there would be no allocable excess of \$60,000 to depreciate or amortize against future operations. Incidentally, the \$20,000 of paid-in surplus arises since the par value of the stock issued by Company A is \$20,000 less than the par value of the stock of the pooled Company B. Thus, the difference is treated as a "reduction surplus."

For further clarification of this matter, see the exchange of correspondence *directly following.*[2]

Inquiry 434

Purchase vs. pooling; stock for net assets and cash for stock, with additional stock issuance and cash payment dependent on future earnings

"We would like to have your opinion on the following accounting problem we have with a client regarding a 'pooling of interests.' The facts are as follows:

"Our client A entered into two agreements on the same date to acquire all the business and net assets of two corporations, X and Y. Corporations X and Y were owned by the same stockholder, both were in the same type of business (garment manufacture) using the same building and having the same management. The principal difference between X and Y was that each corporation had a different class of customers and made different styles of goods.

"The agreement to acquire X was between A and X, and was for the sale of all net assets and business in exchange for 9,000 shares of A's common stock plus an additional 9,000 shares provided the earnings of business acquired from X over the following 5 years exceeded a specified amount. The common stock of A has a par value of \$1, book value of \$10 and a market value of \$24 (traded on ASE). The business of X will be kept intact and operated as a separate autonomous division of A.

"The agreement to acquire Y was between Corporation A and the

[2] See also the item entitled "Long-Range Commitments in Handling New Subsidiaries" which appeared in Carman G. Blough's column in the September, 1957 issue of *The Journal of Accountancy*. We believe this should help to further clarify and distinguish the "purchase" and "pooling" accounting effects.

sole stockholder of Y, and was for the sale of all stock in Y to A for $1,250,000 cash plus an additional $750,000 payable after 5 years provided the earnings of Y for these 5 years exceeded a specific amount. The business of Y will be kept intact and this corporation operated as a wholly-owned subsidiary of A.

"Both agreements specify that the sole stockholder and chief operating officer of X and Y is to remain as manager of both businesses and will be on the board of directors of A for 5 years. He is to have autonomous control over the business of X and Y during this 5-year period, even to the extent that he can have different attorneys, accountants, etc., than A. The acquisition of his future services was an important reason for A to acquire these two businesses. He also signed a non-compete agreement.

"The approximate size of the three corporations is indicated as follows:

	A	X	Y
Total assets	$18,000,000	$ 250,000	$2,000,000
Total sales	40,000,000	1,000,000	6,000,000
Total net worth	8,000,000	170,000	850,000

"The purchase of Y was recorded as follows (as shown by consolidating with A and subsidiaries):

	Dr.	*Cr.*
Net assets (at appraised value)	$1,200,000	
Intangible asset (goodwill)	800,000*	
Cash		$1,250,000
Liability (contingent on future earnings)		750,000

*To be amortized over 15 years by straight-line method, by annual charges against income.

"The problem here is the method of recording the acquisition of X. A recap of the salient figures is as follows:

Total par value of stock issued for X @ 1.00	$ 18,000
Total book value of stock @ 10.00	180,000
Total market value of stock @ 24.00	432,000
Book value of net worth of X	170,000

"By treating this as a pooling of interests, Corporation A avoids a charge against income for a writeoff of the excess of cost ($432,000) over book value ($170,000). In the purchase of Y such excess (goodwill) is being written off.

INQUIRY: **434**

"Our client A wants to treat this as a 'pooling of interests,' and we naturally want to oblige if we have reasonable grounds for our stand. Incidentally, a national accounting firm has given our client a verbal opinion that this could be treated as a pooling of interests and, based on our study and research, we are inclined to agree. Can you please give us your opinion and the reasons therefor?"

Our Opinion

From the standpoint of what may be described as a *formal* application of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), we believe that the transaction between A and X may be treated as a "pooling of interests," *provided that* the sole stockholder and chief operating officer of X after the combination holds more than 5 per cent of the voting interest in the combined enterprise (see par. 6, p. 23, of *A.R.B. No. 48*). If this condition is met, apparently then, according to the letter of the *Bulletin,* this is sufficient to rebut the presumption that the transaction is a "purchase." We personally are in no position to gainsay the *Bulletin,* especially when other factors deemed pertinent by the *Bulletin* are present, such as "continuity" of business operations and management of X. These latter two factors, of course, are present in many "purchase" situations.

For your further guidance in this matter, we would call your attention to the item entitled "Some Observations on Pooling of Interests" which appeared in Carman G. Blough's column at pp. 73-4 of the September, 1960 issue of *The Journal of Accountancy.*

We understand that Mr. Blough was impelled to set down his observations on this matter since he felt strongly, and a number of practitioners with whom he had discussed the matter agreed with him, that the "pooling" concept or treatment had been carried much too far – to the extent that several cases were observed where the former ownership interests of constituents ended up with only 1 per cent or 2 per cent voting interests in combined enterprises.[1]

It appears that borderline cases (involving an excess of fair value of stock issued over book value of net assets acquired) have invariably

[1] In the article "Distinguishing Between Purchase and Pooling," by S. R. Sapienza (June, 1961 issue of *The Journal of Accountancy*), see the references to the Cuno Engineering Corporation and Wen-Mac Corporation cases (2nd column, p. 39) and see also Table II on p. 40.

been handled as a pooling rather than as a purchase. Is this sound or sinister?

The "last chapter," so to speak, has not as yet been written on the pooling of interests. What is not discerned or at least frankly and explicitly recognized by those who write about it, is the fact that the pooling "controversy" is basically an issue between the "revaluationists" and the advocates of strict adherence to historical cost.[2]

Thus, some accountants might argue ad hominem, as if to stigmatize it at the outset, that the "generally accepted" pooling concept of carrying forward the constituent's net assets at book value is a tax concept in disguise [what we have in mind is certain tax-free reorganizations (mergers or exchanges) where the acquiring corporation uses a "substituted basis," i.e., determines basis by reference to the basis of the *same* property in the hands of *another* person, its transferor's basis]; that its application is an unwarranted exception to, and erosion of, the generally accepted accounting principle governing arms-length non-cash transactions (exchange of stock, for stock or property); and that it frequently results in substantial deflation or a "hidden reserve" in the balance sheet together with inflation of reported income.[3]

On the other hand, we personally would accept the validity of the tax analogy, and argue that the tax treatment of Clause A, B, and C reorganizations (involving statutory merger or consolidation; acquisition, stock for stock; and acquisition, stock for properties, respectively), involves a policy of firm adherence to the generally accepted accounting principle of historical cost, since the basis (generally cost) of the pooled constituent is required to be taken over onto the books of the acquiring entity for tax purposes in the same manner as such cost is required to be "carried forward" in accordance with the pooling concept.

Further, we would argue that rather than being an unwarranted exception to the non-cash-transaction rule, on the contrary, one might well examine the question whether the non-cash-transaction rule should have *any* relevance or application at all when issuance of a company's own stock is involved, since in issuing its own stock for

2 See the article "Why Not Retain Historical Cost?", by Eric L. Kohler (in *The Journal of Accountancy* for October, 1963, at pp. 35-41).

3 Anent this latter, in addition to Mr. Blough's remark about "the struggle of corporate managements to avoid accountability for acquired intangibles," see the Summary at the end of the Sapienza article, especially conclusion "3."

assets or stock of another company, the acquiring company makes no immediate outlay of its own assets whatsoever (as with the stock dividend issuance, there is no distribution, division, or severance of corporate assets). If net assets are taken over and *debt assumed* by the acquiring corporation, the latter consideration is, of course, recognized as a liability on the acquiring corporation's books.

Finally, as for the balance-sheet deflation or "hidden reserve" argument previously mentioned — we would point out that resort to *market value of stock issued* as a basis for measuring a "new cost" for acquired stock or assets is no different than any other upward departure from historical cost; that the excess of the market value of stock issued over original cost to the acquired constituent is essentially a capitalization of future earnings, an unrealized increment which on the asset side, it should be stressed, has no future tax-deductibility; or stated differently, such excess if recorded, represents a *hypothetical cost,* for it involves no actual current outlay of assets by the acquiring corporation.

To advert to your specific problem after this somewhat lengthy aside: Regarding your treatment of the cash purchase of the stock of Y, in our opinion, the additional $750,000 "payable after 5 years provided the earnings of Y for these 5 years exceeded a specific amount" is a *contingent* liability. The $750,000 ripens into an actual liability only when, as, and if the requisite earnings materialize. Accordingly, we personally believe that $750,000 of the Goodwill and the $750,000 liability should be excluded from the statement proper with continuing disclosure of the details of the contingent liability in a footnote to the statements until such time as an actual liability arises. We do not have strong objections to your treatment, however, if there is a high degree of probability that the $750,000 will have to be paid in ordinary course. Your parenthetical explanation of the liability, viz., "contingent on future earnings," is salutary.

However, if the $800,000 of Goodwill *is* to be reflected in the statement proper — especially if it is deemed to represent a payment for 5 years' earnings or differential earnings, then it seems to us the amortization period might well be 5 years on the grounds that the purchase "cost" of the earnings should be matched with such earnings as they materialize or that the cost of the purchased Goodwill should be "recovered" out of earnings prior to the time when the prospective liability, if any, must be paid.

Regarding the additional 9,000 shares required to be issued in accordance with the agreement between A and X, "provided the earnings of business acquired from X over the following 5 years exceeded a specified amount" – it seems to us Corporation A need only disclose the provision in a footnote to its statements and perhaps earmark 9,000 of its authorized but unissued shares as being reserved for this purpose.

Inquiry **435**

Corporate acquisition of assets — "purchase" or "pooling"?

"Corporation A proposes to acquire all of the assets and to assume the liabilities of Corporation B by giving Corporation B, say, 160,000 shares $1 par common of Corporation A.

"After acquisition, what is the status of Capital Surplus and Earned Surplus? If there be an Earned Surplus, is it available for dividends? Corporation attorneys and independent accountants disagree. The condensed figures are as follows:

			After Acquisition	
Assets	*Corp. A*	*Corp. B*	*Per CPA*	*Per Att'y*
Current	$ 800,000	$1,700,000	$2,500,000	$2,500,000
Deferred and Prepaid	400,000	40,000	440,000	440,000
Fixed–net	3,500,000	260,000	3,760,000	3,760,000
	$4,700,000	$2,000,000	$6,700,000	$6,700,000
Liabilities				
Current	$ 800,000	$ 300,000	$1,100,000	$1,100,000
Other Liabilities	550,000	230,000	780,000	780,000
Capital Stock	700,000	210,000	860,000	860,000
Capital Surplus	2,750,000	60,000	4,060,000	2,860,000
Earned Surplus	(100,000)	1,200,000	(100,000)	1,100,000
	$4,700,000	$2,000,000	$6,700,000	$6,700,000

Our Opinion

Your query is: After acquisition, what is the status of Capital Surplus and Earned Surplus? A succinct answer to this question is that the "status" of these accounts after the business combination from legal, tax, and financial presentation standpoints, may not coincide.

As a matter of policy, we do not undertake to give opinions on tax aspects; we are not in a position to give opinions on legal aspects.

From the standpoint of proper financial presentation, whether the condensed presentation of the attorney or of the CPA is "right," depends, in our opinion, on whether the business combination is deemed to be a "purchase" or a "pooling of interests." In this connection, see *Accounting Research Bulletin No. 48, Business Combinations* [AICPA, 1957, superseding chapter 7C of *A.R.B. No. 43*].

If the business combination in question may be deemed and is treated as a "pooling of interests," the attorney's presentation, after "acquisition," would be proper (see par's 9 and 11 of *A.R.B. No. 48*). If on the other hand, the transaction is construed and treated as a "purchase," then the CPA's presentation, after acquisition, may or may not be proper (see par. 8 of *A.R.B. No. 48*). Assuming a "purchase," we believe the CPA's presentation of net worth elements would be proper only if the carrying amounts of the net assets transferred from B to A represent the *fair value* of the consideration given for the 160,000 shares of stock (or conversely, if the fair value of the stock may realistically be deemed to equal the book value of the net assets acquired). However, if the fair value of the net assets acquired is more or less than the book or carrying value thereof, then the capital paid in on the 160,000 shares would have to be recorded in terms of such fair value.

In this connection, the fact that the book value of net assets contributed to the combination by B represents about 30.4 per cent of the total net assets while 160,000 shares issued to the ownership group in B represents only 18.6 per cent of the total capital stock outstanding after the combination, may or may not be relevant.

If one construes the transaction as a "purchase," and pursuant to the non-cash-transaction rule set forth in par. 8 of *A.R.B. No. 48*, the acquired net assets are recorded at a "fair value" exceeding their carrying value or tax basis on the transferor's books, and if the transaction nevertheless qualifies as a tax-free reorganization under Clause C of IRC section 368(a)(1) [which means that the tax basis of the property in the hands of the acquiring corporation is the same basis that the property had in the hands of the transferor] — then, serious consideration should be given to *reducing* the recorded "fair values" of the acquired property by an *allowance* account measuring the future non-tax-deductibility of that portion of recorded value exceeding the tax basis (tax rate times the $ increment).

Incidentally, regardless of whether the transaction described in your letter is treated as a "purchase" or as a "pooling of interests" for financial accounting purposes, the necessity for a separate computation of "earnings and profits" for tax purposes is indicated.[1]

Inquiry **436**

Pooling of interests — constituent having 50 per cent stock ownership interest in other constituent, prior to acquiring 100 per cent interest

"I would appreciate it if you could give me your opinion as to whether the situation stated below involves a pooling of interests or a purchase.

"The circumstances behind the request are purely personal — a disagreement with a fellow Certified Public Accountant. Therefore, the facts and conditions are entirely hypothetical. Please feel free to interject additional conditions, if needed.

"The agreed facts and conditions are as follows:

1. Company A and Company B each own 50 per cent of the outstanding stock of Company C.
2. Company C's capital structure is as follows:
   Cumulative Preferred Stock —
     Issued and outstanding — 8,000 shares
   Common Stock —
     Issued and outstanding — 6,000 shares

[1] This correspondence pre-dated the publication of *Accounting Research Study No. 5, A Critical Study of Accounting for Business Combinations,* by A. R. Wyatt (AICPA, 1963).

3. Company A and Company B have agreed as follows:
   a. Company A will issue to Company B a specified number of shares of its unissued authorized common stock. Such shares are to be equal in par or stated value to Company B's interest in Company C.
   b. Company B will transfer its entire interest in Company C to Company A.
4. The preferred stock of Company C will be retired.
5. Company C will be a wholly-owned subsidiary of Company A.
6. Company B will have control of about one-third of the voting stock of Company A.
7. Company A and Company C are engaged in like activities.
8. Company A and Company C are relatively equal in size.
9. The management of both companies will continue as is."

Our Opinion

In our opinion, the transaction described in your letter meets the main criteria of a "pooling of interests" as set forth in par's 4 through 7 of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957). A key question here, it seems to us, is whether after the exchange of shares, a "new ownership" of, or a "continuity of old ownership" of, Corporation C results. We conclude that there is a continuity of the old ownership interest pari passu; Corporation B has substituted indirect ownership of C (by acquiring a 1/3 direct stock ownership of A) for a 1/2 direct stock ownership of C.

The principal feature distinguishing the case you outline from the more "normal" pooling situation is the fact that prior to the pooling, one of the constituents involved in the pooling already has a stock ownership interest in the other constituent involved. We fail to see how such fact would preclude construing the transaction as one resulting in a pooling.

We note also that C is kept alive as a subsidiary of A. According to the last sentence, par. 4, of *A.R.B. No. 48,* this "does not prevent the combination from being a pooling of interests if no significant minority interest remains outstanding. . . ."

As we see it, none of the other agreed facts and conditions recited in your letter militate against the pooling conclusion.

436 :INQUIRY

Inquiry 437

Pooling of interests, where minority interest in acquired subsidiary remains, or may remain outstanding

"We would appreciate an expression of opinion from you as to the proposed accounting treatment of the following transaction.

"The parent company has a net worth consisting of:

Common stock – $3 par value	
Issued 3,270,756 shares	$ 9,812,268
Additional paid-in capital	425,935
Income retained in the business	33,421,793
	$43,659,996
Less: Treasury stock	
619,856 shares	1,021,519
	$42,638,477

"The company to be acquired (hereinafter called the subsidiary) has net worth consisting of:

Preferred stock – 5% cumulative, $6 par value	
Issued 134,996 shares	$ 809,976
Common stock – $3 par value	
Issued 936,970 shares	2,810,910
Paid-in surplus	175,500
Earned surplus	5,642,366
	$9,438,752

"The parent company intends to issue 408,000 shares of its $3 par common stock and 157,000 shares of a new $10 par preferred stock for all of the common stock of the subsidiary. The new preferred stock will be convertible into common stock on a share for share basis, and both the common stock and the new preferred stock will have one vote per share. The non-voting preferred stock of the subsidiary company will be retired for cash prior to the exchange.

"The stock of the parent company is traded on the New York Stock Exchange; that of the subsidiary is closely-held in a voting trust. The exchange of stock is based upon an arms-length evaluation of the relative values of the respective companies. The transaction seems to fit all of the requirements of *Accounting Research Bulletin No. 48* in that:

"1. All of the ownership interests in the constituent corporations become the owners of a single corporation, which owns the assets and businesses of the constituent corporations.

"2. Ownership by the several owners of the predecessor corporations will be substantially in proportion to their respective interests in the predecessor corporations.

"3. Relative voting rights, as between the constituents, will not be materially altered.

"4. There is no present intention to retire any portion of the capital stock issued to the owners of the constituent corporations, except the retirement of the preferred stock of the subsidiary which was mentioned above. Paragraph 5 of *Bulletin No. 48* states that such a retirement need not prevent the combination from being a pooling of interests.

"5. At present it is the intention of management to continue all divisions of both businesses without substantial change.

"6. It is presently contemplated to continue all of the key people in both corporations in important management positions.

"7. The stockholders of the parent company will own substantially less than 90 per cent of the combined corporation.

"Consequently, it is proposed to treat this transaction as a pooling of interests. The stock to be issued will be recorded at its par value – $2,794,000; and on consolidation, the common stock of the subsidiary – $2,811,000 – will be eliminated, thus producing capital surplus of $17,000. Thus, the earned surplus of the two constituent companies will be carried forward as earned surplus of the combined corporation. When and if the voting preferred stock is converted to common stock, the common stock will be increased by $471,000 and capital surplus will be increased by $1,099,000.

"One further point: The exchange offer is conditioned upon the acceptance of the plan by at least 80 per cent of the shares of the subsidiary. If only 80 per cent accept the offer at this time, we still intend to treat the transaction as a pooling of interests because of the expectation that the remaining stockholders of the subsidiary will accept the offer in the relatively near future."

Our Opinion

In our opinion, the transaction described in your letter may properly be deemed a "pooling of interests." We believe it meets the cumulative criteria of a "pooling of interests" as set forth in *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), in all substantial respects.

It seems to us if one *were* to question treatment of the transaction as a "pooling," the principal point of vulnerability would be in the contention that "substantially all" of the ownership interests in the constituent corporations *may not* become the owners of a single corporation which owns the assets and businesses of the constituent corporations. To put it another way, although the fact that one of the constituents in a combination is kept alive as a subsidiary does not necessarily preclude a "pooling," nevertheless, one might contend that treatment as a "pooling" is precluded here because a "significant minority interest" remains, or may remain, outstanding.

Personally, we do not believe such contentions should be given much weight here, whether or not a minority interest in the subsidiary materializes. In our opinion, principal weight should be given to the fact that the combination is characterized by a continuity of the ownership interests and management which effectively controlled the constituents prior to the combination. To put it negatively, it does not appear that an important part of the ownership or controlling interests in the acquired corporation is, or will be, eliminated by the combination.

It almost goes without saying, we attach considerable weight also to the fact that the transaction meets the percentage test for a "pooling" set forth in par. 6 of *A.R.B. No. 48.*

Incidentally, we believe the elimination entry described in the next to the last paragraph of your letter, is proper, in that it accords with the accounting treatment contemplated by the last sentence of par. 11 of *A.R.B. No. 48.*

INQUIRY: 437

Inquiry **438**

Merger (pooling) of parent with company making substantial profit on sale to unconsolidated subsidiary — treatment of intercompany profit

"We would be interested in your comments on the following:

"Blank Industries, Inc. (A) has a wholly-owned Israeli subsidiary (B). A carries its investment in B at cost (cost being market value of common stock issued) and does not include B in its consolidation.

"A is presently discussing merger terms with C, a U.S. company. C has had recent transactions with B, resulting in considerable profit to C with the underlying property carried by B in fixed assets. The charges by C to B have not yet been paid and are carried in accounts receivable on the books of C.

"A is preparing a pro forma balance sheet and income statement giving effect to the merger (A and C) and continues to show B as an investment at original cost.

"Comments would be appreciated as to (1) the degree and method of disclosing the 'intercompany profit' in the pro forma statements as well as future annual reports of the merged company and (2) the same as (1) above assuming that shortly after the merger, B will sell the items billed them by C."

Our Opinion

Perhaps we should initially raise a question for your consideration, viz., as to whether A should carry the investment in its wholly-owned Israeli subsidiary B at "cost" measured by the market value of the stock it issued to acquire B's stock. Query whether the issuance of stock for stock should be treated (or should have been treated) as a "pooling of interests" between A and B? [See *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957).] Even if no "pooling," what is the reason for not consolidating B? Is it perchance because of restrictions on the transfer of funds?

These points having been raised, we can now turn to your specific questions.

As we view it, upon the merger of A and C, the accounting therefor will differ depending on whether the merger is effected in the form of a "purchase" or "pooling of interests."

If treated as a *purchase,* the substantial profit to C resulting from its sale of fixed assets to B and which would be reflected in C's earned surplus, would not be carried forward *as earned surplus on the books* of continuing company A. However, part of A's purchase cost for the net assets of C would be the amount of the receivable from B. Thus, at the point of merger by purchase of C's net assets, it is as if A had in effect made an advance to B in the amount of the purchase price of the fixed assets acquired by B from C. Stated somewhat differently, it is as if A had paid C *in behalf of B* for the fixed assets acquired by B.

On the other hand, if the merger is accounted for as a *pooling of interests* (and most "mergers" properly called such would be so treated), then C's earned surplus [including C's substantial profit on its sale of fixed assets to B] would be "carried forward" and reflected as part of the combined earned surplus of continuing company A.

Once A and C are merged by a "pooling," then as we see it, it is *as if* parent A had sold fixed assets to unconsolidated subsidiary B at a substantial profit. However, based on the fifth sentence of par. 20 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959, q.v.), it appears that since the investment in B "is carried at cost, *it is not necessary to eliminate the intercompany gain*[1] on sales to such . . . (unconsolidated subsidiary), if the gain on the sales does not exceed the unrecorded equity in undistributed earnings of the unconsolidated subsidiary." However, it should be noted that the sixth sentence of par. 20 goes on to say: "If such gain is material, it should be appropriately disclosed."[2]

It is to be emphasized that if A is to continue to follow the policy of

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[1] *Our emphasis.* Apparently this conclusion is based on the thought that, if it so elected, the parent could "take up" the undistributed profits of the subsidiary, i.e., recognize or reflect same on its own books (see par. 19, *A.R.B. No. 51*); and that so long as the parent's profit on the transaction with the unconsolidated subsidiary does not exceed the amount of undistributed profits it could realize from the subsidiary, the parent's accounts may not be deemed unduly inflated in any respect.

Incidentally, it is to be stressed again, that in our first paragraph, we questioned whether A is properly measuring the "cost" of its investment in B.

[2] In the article "Some Problems Regarding Consolidated and Parent Company Statements" by AICPA Research Department, in *The Journal of Accountancy* for November, 1953, see question and answer number 17 at p. 576.

not consolidating subsidiary B, then the disclosures mentioned in the last sentence of par. 19, *A.R.B. No. 51,* should also be made.

Regarding item "(2)" in the last paragraph of your letter, it seems to us no elimination need be made, since based on hindsight, i.e., the post-balance-sheet-date event of B's selling the fixed assets acquired from C, there is no longer any intercompany profit on an asset remaining within the consolidated and/or affiliated group (see par. 6, *A.R.B. No. 51*).

The intercompany receivable from B, the unconsolidated subsidiary, on the pro forma balance sheet of the merged companies A and C, should, of course, be clearly described as a "Receivable from Unconsolidated Subsidiary B." If there is no intent to collect or realize upon such receivable in the immediate future, consideration might be given to the desirability of reclassifying such receivable as an *advance* to B, i.e., looking upon the amount involved as additional long-term investment in B.

Inquiry **439**

Effecting quasi-reorganization upon a pooling of interests

"We are presently engaged in the reorganization of two companies which we believe constitutes a pooling of interests. In connection with this reorganization, the company being acquired has a substantial deficit in earned surplus which is considerably larger than the earned surplus of the acquiring corporation.

"I would appreciate it very much if you could give me some references to published material which would assist us in determining the proper accounting treatment of this combination."

Our Opinion

Although we are not aware of any extended discussion of the accounting for a fact situation such as the one briefly characterized in your letter, we believe your basic guides in accounting for the "pooling of interests" should be:

1. Chapter 7A, "Quasi-Reorganization or Corporate Readjustment," in *Accounting Research Bulletin No. 43* (AICPA, 1953).
2. *Accounting Research Bulletin No. 46,* "Discontinuance of Dating Earned Surplus" (AICPA, 1956).
3. *Accounting Research Bulletin No. 48*, "Business Combinations" (AICPA, 1957). See especially par. 9, as well as par's 11 and 12, thereof.

Assuming that the two companies are involved in a merger (involving an exchange of stock of the continuing company for stock of the absorbed company), note par. 9 of *A.R.B. No. 48,* viz.:

> 9. When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried forward; *and the combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward,* except to the extent otherwise required by law or appropriate corporate action. Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; however, *the pooling-of-interests concept implies a combining of surpluses and deficits of the constituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.* (*our emphasis*)

We believe the language which we have emphasized has particular relevance to your client's situation and would effectively proscribe an accounting quasi-reorganization of the company with the substantial deficit *prior to carrying out the pooling.*

It seems to us the question is moot (or not clearly resolved by the *Bulletin*) whether an *accounting* quasi-reorganization may properly be carried out concurrently with the "pooling" or *legal* reorganization, or shortly thereafter – with full disclosure, of course, and subsequent dating of the earned surplus of the continuing or reorganized company thereafter. The first part of the last sentence of par. 9 of *A.R.B. No. 48* suggests that this *may* be acceptable. In any event, if an accounting "quasi" simultaneous with or shortly after the "pooling" *were* effected, we believe the rule of informative disclosure would require that the continuing corporation's earned surplus be dated thereafter and described in such manner as to call the statement-reader's attention to the fact that a readjustment involving a writeoff of a combined net deficit had been made.

In a case such as this (an assumed merger situation), if paid-in or capital surplus (either on the continuing company's or acquired company's balance sheet) were not available for carryover in the combined balance sheet sufficient to absorb the writeoff of the net deficit upon giving effect to the quasi-reorganization, the neat thing, of course, from the standpoint of accounting convenience, would be for the acquiring company at the outset to issue additional shares with a total par value *less* than the total par value of the acquired company's shares *by the amount of* the net deficit to be later written off — i.e., a reduction surplus built into the transaction by setting an appropriate exchange ratio between the total par values of the respective shares exchanged.

However, as a practical matter, it may not be possible to consummate the transaction based on an exchange ratio between par values of the respective stocks which would suit the accounting convenience. The par values and market values of the respective stocks involved in the exchange, and the actual "bargained value" assigned to the net assets of the acquired company by the parties negotiating the transaction, may be such that a reduction surplus sufficient in amount to absorb the net deficit cannot be conveniently carried forward. In such event, either concurrently with the merger or shortly thereafter, the total stated capital of the continuing company would have to be scaled down sufficiently to create the requisite amount of reduction surplus.

Inquiry **440**

Statutory consolidation (pooling), where total liabilities assumed exceed total assets acquired

"I have an accounting problem in connection with a statutory merger which involves the following facts:

"Corporation C, a newly-organized corporation, having an authorized capital of $2,000, has made arrangements to acquire all of the assets and to assume all of the liabilities of Corporations A and B. Corporations A and B have balance sheets as follows:

	Corporation A		Corporation B	
Assets		$10,000		$20,000
Liabilities		$20,000		$15,000
Stockholders' equity:				
Capital	$ 1,000		$1,000	
Surplus (deficit)	(11,000)	(10,000)	4,000	5,000
		$10,000		$20,000

"In exchange for the assets and liabilities transferred to Corporation C, Corporations A and B will each receive $1,000 worth of the fully-paid capital stock of Corporation C.

"It is realized that the new corporation will be insolvent as soon as this exchange has been completed, and it is believed that this approach should be taken to the merger in deference to tax problems which exist. Immediately after the exchange has been made, the capital of the acquiring corporation will be substantially increased and paid in cash to correct this situation. Corporations A and B are wholly-owned subsidiaries of Corporation X, and upon completion of the merger and liquidation of Corporations A and B, the liquidating distribution will make Corporation C a wholly-owned subsidiary of Corporation X.

"I would appreciate your opinion as to the proper accounting treatment to be accorded the deficit of Corporation A and the surplus of Corporation B on the books of the acquiring Corporation C."

Our Opinion

In our opinion, the legal consolidation of Corporations A and B described in your letter should be treated accounting-wise as a "pooling of interests." [See *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), especially par's 4 and 11 thereof.] Accordingly, since the newly-organized Corporation C will have (at the outset, so it is intended) a stated capital equal to the total of the stated capitals of the constituent corporations, it appears if considered solely from the standpoint of *A.R.B. No. 48,* that all that needs to be done in accounting for the deficit of Corporation A and the surplus of Corporation B is to pool or merge the two accounts and carry forward a net deficit of $7,000 ($11,000 minus $4,000).

However, if the state of incorporation is one with a statutory requirement that a corporation must have a so-called "minimum capitalization" or a requirement that its issued stock must be "fully-paid," as a prerequisite to its being organized de jure, then query whether a corporation purportedly organized to effect a legal consolidation may be deemed to be organized *de jure* if it commences its operations with a deficit, i.e., if it is insolvent when it commences its operations?

If perchance there is a statutory requirement that *any* corporation (whether or not organized pursuant to a legal consolidation) must commence business with a minimum fully-paid-in capitalization of, say, $2,000, and Corporation C issues stock with a par or stated value of that amount in consideration for taking over assets with a book value of $30,000 (which we will assume is *not less than* their fair value) and assuming liabilities of $35,000, then it would appear that the newly-organized Corporation C has issued its stock for a *minus* consideration, viz., having assumed liabilities which exceed assets by $5,000, and accordingly, that a minimum of $7,000 of new consideration would have to be paid into Corporation C in order to provide sufficient paid-in surplus against which to write off the net deficit and commence business with the assumed requisite amount of fully-paid-in capital stock.

If our assumptions above as to values, statutory requirements, and legal effect are valid, and *if* new or additional consideration of at least $7,000 is not immediately paid in, then we believe the following journal entry would factually portray Corporation C's acquisition of assets, assumption of liabilities, and issuance of stock, upon its inception, viz.:

Dr. Assets	$30,000	
Excess of Liabilities Assumed Over Assets Acquired	5,000	
Stock Discount	2,000	
Cr. Liabilities		$35,000
Capital Stock Issued and Outstanding		2,000

Inquiry 441

Stock discount arising upon a pooling of interests

"We have the following accounting problem and would appreciate your advice.

FACTS

"1. In a 'pooling of interests' combination, Corporation P consummated the following transactions:

a. Increased its authorized capital stock from a par or stated value of $5,000 (old stock) to $1,000,000 (new stock).
b. Issued $425,000 new stock to the stockholders of Corporations A and B for 100 per cent of the capital stock of A and B.
c. Issued $315,000 of new stock to its *own* stockholders for $5,000 of its old stock.

"2. The combined net book value of Corporations A and B approximately equals the stock issued by P ($425,000).

"3. Corporation P's surplus at the time of completion of the transaction was $220,000, with no capital surplus.

"4. The amount of new stock issued ($315,000) to its own stockholders for its old stock ($5,000) was determined by the same formula as that used in determining the amount of new stock issued for the stock of A and B. This increase in value was attributable to the value of unrealized contracts receivable.

COMMENT

"We have reviewed the Institute's *Accounting Research Bulletins No. 43* (chapter 7) and *48,* which indicate that where the stated capital after a pooling of interests transaction is more than the stated capital prior to the combination, the excess shall be charged first to capital surplus and then to earned surplus. The *Bulletins*, however, do not indicate the procedure to follow when the excess exceeds both capital and earned surplus. We have also reviewed the 1959 issue of *Accounting Trends and Techniques* but are unable to find any similar situation.

QUESTIONS

"1. Should Corporation P charge $220,000 of the $310,000 excess of new stated capital over old stated capital against surplus, thereby reducing earned surplus to nil?

"2. What should the debit account of $90,000 if earned surplus is charged off, or $310,000 if earned surplus is not charged off, be titled in the bookkeeping records?

"3. How should this debit account be shown on the individual balance sheet of P?

"4. Should this debit account be charged against the combined earned surplus on a consolidated balance sheet?"

Our Opinion

1. In our opinion, assuming that Corporation P is organized in the state whence your letter comes, viz., Oregon, then it appears such corporation may properly charge $220,000 of the $310,000 excess of new stated capital over old stated capital to surplus. In this connection, we note that section 57.100 of the *Oregon Business Corporation Act* (which section deals with "Consideration for Shares") states the following, in part:

> In the event of a conversion of shares, or in the event of an exchange of shares with or without par value for the same or a different number of shares with or without par value, whether of the same or a different class or classes, the consideration for the shares so issued in exchange or conversion shall be deemed to be: (a) the stated capital then represented by the shares so exchanged or converted, and (b) that part of surplus, if any, transferred to stated capital upon the issuance of shares for the shares so exchanged or converted, and (c) any additional consideration paid to the corporation upon the issuance of shares for the shares so exchanged or converted.

This language, incidentally, is the same as that appearing in section 17 of the *Model Business Corporation Act* (published by American Law Institute collaborating with American Bar Association, revised, 1953).

2. and 3. If $220,000 of the excess is transferred from earned surplus to stated capital, i.e., to the capital stock account of the parent as seems to be contemplated by the statute, then in our opinion, the remaining $90,000 should be recorded on the books and reflected in the financial statements of Corporation P as stock discount. In the absence of any charge to earned surplus, an alternative which, in view of the statutory provision, we would not seriously consider, then we believe $310,000 would have to be recorded and reflected as stock discount.

4. It appears from the language of par. 11 of *A.R.B. No. 48* that the excess amount in question may be charged against the combined earned surplus on the combined or consolidated balance sheet [viz.: "... the excess may be deducted first from the total of any other contributed capital (capital surplus), and next from the total of any earned surplus, of the constituent corporations"]. If the legal effect of the exchange of new for old shares is such that it results in stock discount which is then absorbed for purposes of combined or consolidated statements in the manner provided in par. 11 of *A.R.B. No. 48*, we would be inclined to disclose the existence and amount of the stock discount in a footnote to such statements.

Since the value of unrealized contracts receivable entered into the formula used in determining the stated value of the new shares to be issued in exchange for the $5,000 of old Corporation P stock, it seems to us you may well explore the propriety of using the specific contract earnings *when realized* to absorb a writeoff of the stock discount, i.e., after first transferring such contract earnings to the earned surplus account. If the Commissioner of Corporations has any jurisdiction in this matter, you may want to sound him out on this manner of disposing of the discount. It would appear that the other stockholding groups would be amenable since the future contract revenues were given weight in the original negotiations.

Inquiry **442**

Purchase of controlling interest in another corporation by loan from third party, collateralized by substantial number of acquired shares

"We would like to have your opinion regarding the financial presentation of the following:

"A Company owns 5,000 shares of B Company which it acquired at a cost of $500,000 ten years ago. B Company is a major supplier of raw materials to A Company. There are 31,000 shares of B Company stock outstanding. B Company stock is owned by approximately 20 stockholders. The book value of B Company stock is $250 per share.

"A Company buys from another stockholder of B an additional 10,600 shares at $210 per share for a total expenditure of $2,226,000, using the proceeds of a loan from C in the amount of $2,400,000 to pay for same. C is not connected with A or B in any way. Ninety-six hundred (9,600) of the acquired shares are pledged as collateral for the loan from C, while 1,000 of the acquired shares are free and clear. In event of default, the principal of the loan will be repayable solely out of the collateral pledged, and A Company will not be liable for any deficiency between the value of the collateral pledged and any unpaid principal balance. The acquisition of the 10,600 shares will enable A Company to control B Company. A Company does not intend to consolidate its figures with B Company.

"Interest on the unpaid principal balance is payable to C quarterly. If, however, A defaults at any time in the payment of such interest, C's sole recourse will be to the collateral pledged.

"At any time within the next ten years, A shall have the right, at its option, to redeem from the collateral pledged, any number of shares in B Company upon payment to C of $250 for each share redeemed. Thereupon, the principal balance of the loan shall be correspondingly reduced.

"Dividends are currently being paid by B Company at a rate which will more than offset the interest paid to C on the loan.

"A Company does not have any present intentions of redeeming the collateral pledged, unless and until it is in the position to sell all or a part of B Company stock at a profit.

"Management would like to have the financial presentation as follows:

On the asset side of the balance sheet:
Investments:

5,000 Shares of B Company @ Cost	$500,000
1,000 Shares of B Company @ Cost	210,000
Total	$710,000

On the liability side of the balance sheet:
Long-Term Liability:

Notes Payable – C	$2,400,000
Less – 9,600 Shares of B Company Stock Pledged	2,016,000
Net Long-Term Liability	$ 384,000

Footnotes would explain the transaction in detail.

"As an alternative treatment, management is also considering the following presentation:

On the asset side of the balance sheet:
Investments:

5,000 Shares of B Company @ Cost	$500,000
1,000 Shares of B Company @ Cost	210,000
Total	$710,000

On the liability side of the balance sheet as part of *Net Worth*:

Capital Surplus	$384,000

The capital surplus reconciliation would indicate the nature of the transaction and, in addition, a footnote would further clarify the situation."

Our Opinion

In our opinion, the first suggested presentation is undesirable; and the second suggested presentation is highly improper.

Regarding the first presentation, although there is some support for making an exception to the general rule against offsetting assets and liabilities in the balance sheet in cases where there is a legal right of setoff (and it appears that there is a right of setoff here with respect to the pledged collateral, albeit preconditioned on an event of default); nevertheless, as stated at p. 363 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957): "It is not considered good practice to deduct long-term debt (obligations) from assets pledged against them."

Apparently, the client would support the first presentation on the ground that it has not assumed liability for the $2,400,000 loan, that it is not "personally liable" therefor, the pledgee C being able to make itself whole or salvage a portion of its advance only by looking to the collateral *in the event of default.* The second presentation goes even further in assuming the contingency (i.e., the default) in advance. This latter presentation reflects the transaction *as if* Company A had defaulted, C had resorted to the collateral, and there had been a resultant cancellation of indebtedness in the amount of the difference between the loan proceeds advanced and the cost of the collateral to Company A.

In our opinion, Company A should reflect the 9,600 shares together with the other 6,000 shares as an investment on the asset side of the balance sheet so long as it derives a continuing business advantage from holding such shares or until such time as it voluntarily or involuntarily changes its position and actually defaults on its interest payments. Personally, we feel the fact that there is no stated present intention of redeeming the collateral, is irrelevant.

A footnote keyed to the investment account should, of course, indicate the number of shares pledged, and should also disclose the essential facts outlined in the fourth and fifth paragraphs of your letter.

Incidentally, although you do not specifically raise the point, you may want to give further consideration to the question whether consolidated statements should be prepared in order to make the most meaningful financial presentation in the circumstances. Regarding this matter, you merely state in your letter: "A Company does not intend to consolidate its figures with B Company." In considering this question, it seems to us the following passage from *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959, at p. 41) is relevant, viz.:

> Consolidation Policy
>
> 2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over

> fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy).

Assuming that the client adheres to its decision not to prepare consolidated statements, then we would urge you to peruse carefully, pp. 46-8 of *A.R.B. No. 51* (par's 19, 20, and 21). We have in mind here principally the fact that "B Company is a major supplier of raw materials to A Company."

Inquiry 443

Exchange of 86 per cent interest in substantial subsidiary for 12 per cent interest in publicly-held corporation

"I have encountered a problem in the proper recording of a transaction entered into by one of our clients for which I seek your suggestions and advice as to proper handling. I have reviewed, several times, *Accounting Research Bulletin No. 48*, and cannot arrive at a clear-cut answer in applying this statement to my situation. The basic facts in this situation are as follows:

"Corporation A, our client, acquired stock in Corporation B in the year 1931. The original cost and present tax basis is $28,134 as of the current date. Corporation A's investment represents an 86 per cent interest in Corporation B's outstanding capital stock. Corporation A also during the years has recorded on its books its increment in Corporation B's net worth. This now represents an amount in excess of 1 million dollars. Corporation A has also during the years paid stock dividends which has resulted in a considerable portion of the 1 million dollars being capitalized in capital stock outstanding. Corporation B's stock has never been listed or sold on any local market. Corporation A has published consolidated financial statements, and their stock has been sold to the local public.

"The following is a condensed balance sheet (not consolidated) of Corporation A as of August 31, 1961:

Assets		
Current Assets		$1,000,000
Other Assets:		
Company B's stock	$1,000,000	
Other	100,000	1,100,000
Property Assets		850,000
Total		$2,950,000
Liabilities		
Current Liabilities		$ 400,000
Stockholders' Equity:		
Common stock	$1,640,000	
Other capital (including revaluation surplus)	300,000	
Retained earnings	610,000	2,550,000
Total		$2,950,000

"Corporation A as a stockholder in Corporation B agreed with other stockholders of Corporation B to exchange Corporation B's stock for the stock of Corporation X. Corporation X's stock is listed on the American Stock Exchange with a current market quotation of approximately $70 per share at the time of the exchange. The stock delivered by Corporation X in the exchange was authorized but unissued capital stock of Corporation X. The resultant exchange places in the hands of our client, Corporation A, Corporation X stock with an approximate market valuation of 3 million dollars and represents an approximate 12 per cent ownership in Corporation X.

"It would seem to me that the above-described transaction would be considered a sale by Corporation A of its Corporation B stock; and that the proper accounting would be to reflect a gain of 2 million dollars and a carrying value on Corporation A's balance sheet of the market value of Corporation X's stock as of the date of exchange."

Our Opinion

Support for the conclusion expressed in the last paragraph of your letter as to what the accounting for the described transaction on the books of Corporation A, should be, may be found in the general rule relating to non-cash transactions, viz.: in the case of non-cash transactions, cost may be considered as being either the fair value of the consideration given or the fair value of the property received, whichever is more clearly evident. It is also apparent that the publicly-quoted market price of Corporation X's stock at date of the exchange is the "more clearly evident" value for cost-measurement purposes.

However, there are other alternative possibilities as to accounting treatment of the transaction in question which, in our personal opinion, should be given serious consideration.

First, we would question your characterization of the transaction as involving simply a "sale" of Corporation B stock. Actually, an *exchange* of like-kind property is involved, the corporate client having *substituted* a 12 per cent interest in the stock of one constituent to a "pooling of interests" (Corporation X) for an 86 per cent controlling interest in the stock of another constituent to the "pooling." An exchange may be said to have both the aspects of a sale *and* a purchase; and the question clearly arises whether application of the so-called non-cash-transaction rule in an exchange situation such as this is a more salutary long-run accounting policy than the alternative policy of attributing the carrying value or cost of the stock given up in the exchange to the new stock acquired, and deferring the recognition of any gain whatsoever. What is involved here, if the gain is to be recognized, is a writeup by reference to the fair market value of the securities received. It is highly probable that the securities of Corporation X will be held "for continuing business advantage." If it is *un*acceptable to write ordinary stock-in-trade up to a higher net realizable (market) value when realization of gain is probable within a relatively short period of time, then is it not equally or even more *un*acceptable to write the securities in question up to market value when there is every likelihood that realization of the increment is deferred to the distant future?

If a new basis of accountability does not arise when a combination (say, of Corporations X and B) is deemed to be a pooling of interests, and accordingly, the carrying amounts of the assets of the constituent corporations must be carried forward — then by the same token, should not an individual or corporate investor exchanging stock of one constituent or "party to the pooling" for stock of another constituent or "party to the pooling," attribute the cost of the stock given up to the new stock received?

The following passage from *Montgomery's Auditing* (Ronald Press

Co., N.Y., 1957, at p. 146) is quite relevant in this connection, viz.:

> When securities have been acquired in exchange for other securities as the result of a consolidation, merger, or other reorganization of the company in which an investment is held, or as the result of the exercise of conversion privileges contained in the terms under which a security was issued, cost is considered to be the cost of the security delivered in exchange, adjusted for any cash paid or received in effecting the exchange.

For its bearing on the fact pattern of the transaction under discussion, perhaps it should be pointed out that IRC section 354 dealing with "Exchanges of Stock and Securities in Certain Reorganizations," provides that "no gain or loss is recognized to a stockholder or security holder if he transfers *stock or securities* in a corporation that is a party to a reorganization and receives solely *stock or securities* of the same corporation or of another corporation that is a party to the reorganization, provided that the exchange is in pursuance of a plan of reorganization." Furthermore, "if property is received on an exchange that is solely in kind . . . the property received on the exchange takes the basis of the property surrendered on the exchange."[1]

If we can assume that the securities of Corporation X now held by Corporation A take the tax basis of the Corporation B securities given up, and if we are to assume further that a gain (based on the non-cash-transaction rule) *is* to be recognized on Corporation A's books, then it seems to us that Corporation A should reduce the recorded market value of its investment in Corporation X stock by an allowance account measuring the amount of taxes that would be payable if the higher recorded value were to be realized. Although dealing with a situation involving direct writeup of securities to a higher market, the following passage at p. 158 of *Montgomery* (*op.cit.*) is relevant in connection with the point just made, viz.:

> When the amount of securities priced at market quotations is in excess of cost, the auditor should consider the necessity of indicating the amount of taxes or expenses which would be incurred

1 For a discussion of IRC section 354 (as well as section 358 which provides the rule for determining the basis of property received in a tax-free exchange under section 354); and for a discussion of the definition of a Clause B reorganization (acquisition, stock for stock) under IRC section 368(a)(1), see Stanley and Kilcullen's *The Federal Income Tax — A Guide to the Law* (Tax Club Press, N.Y., 1955, cum supp.) at pp. 149, 159, and 165, *et seq.*

> if the securities were disposed of at the indicated amount to avoid any implication that the entire amount of unrealized gain would be an increment to surplus. Ordinarily, commissions, transfer taxes, and similar expenses are not of sufficient significance to require consideration. However, federal and state taxes on gains may be material in amount and, if they are, appropriate allowance or provision for them should be made as a reduction of indicated unrealized gain. It is not contemplated, however, that this rule should be applied to casual holdings of marketable securities by industrial companies.

Anent the reference in your letter to the possible applicability of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957): While Corporation X will have to give serious consideration to the question whether it should treat the acquisition of Corporation B's stock as a "purchase" or as a "pooling of interests," nevertheless, in our opinion, the *Bulletin* is basically inapplicable to your client's accounting except insofar as it reiterates the non-cash-transaction rule in par. 8 thereof.

Inquiry 444

Property acquired at organization for preferred and common stock; acquisition of preferred and common shares as treasury stock "unit," and subsequent use of cash and common shares of treasury stock "unit" to acquire stock of subsidiary

"It will be much appreciated if you will advise the proper way for handling the purchases of treasury stock and the one disposition of treasury stock in which transactions have occurred approximately as outlined in the paragraphs which follow.

"In December, 1956, 5,000 shares of common stock of a par value of $2.50 and 5,000 shares of 6 per cent preferred stock $10 par value (non-cumulative, non-participating, non-voting, preferred as to assets) of Corporation B were issued to Corporation A in exchange for a tract of undeveloped real estate having a value of approximately $62,500.

Since this was the first issue of stock, and the real estate represented the only corporate asset, the original issues of stock were recorded at par value. Immediately thereafter, in a taxable spin-off, the stock of Corporation B was distributed to the stockholders of Corporation A, numbering about 125.

"In January, 1957, the stockholders of Corporation B were offered additional common stock at $5 per share and 24,000 shares were subscribed and issued at $5 per share, one-half of which was entered as capital paid in, in excess of par value of common shares issued.

"In December, 1957, the corporation advised its shareholders it would consider tenders of units of its stock (one share of common and one share of preferred) at prices not to exceed $11.25 for the unit. Under this offer, units were purchased at prices varying from $9.75 to $11.25, the average being about $10.90 for approximately 1,500 units. Subsequently, one stockholder sold his preferred stock to the corporation at $3 per share.

"In December, 1957, the stockholders waived all pre-emptive rights, and in April, 1958, the corporation began selling units, each made up of 50 shares of common stock and $500 of 6 per cent subordinated term notes due in 1980, for a unit price of $1,000. Approximately 300 of such units were sold by July, 1958.

"The corporation acquired a subsidiary corporation at book value in October, 1958, for approximately $12,000, paying one-half of the purchase price in cash and the remainder by issuing 480 shares of common treasury stock at $12.50 per share.

"All of the foregoing has occurred during a period when the corporation was in the process of getting set up for operations, which will not reach full scale production until about the end of 1959. During the first year of its existence the corporation had an operating loss of approximately $40,000 and during the second year a loss of approximately $60,000.

"We would like to have some help on the following questions:

"1. Did we err a year ago in allowing a statement to go out setting forth the value of the real estate at $62,500 and showing the common and preferred stock issued in exchange for it at par value?

"2. Can we show the units of treasury stock held in the balance sheet at cost without breaking the total down between common and preferred? If we must break it down, what basis should be used?

"3. If we do not divide the cost of the units of treasury stock purchased between common and preferred, how shall we account for the shares of common treasury stock issued in the settlement for the purchase of the stock of the subsidiary corporation?"

Our Opinion

1. Regarding your first specific question as to whether the tract of undeveloped real estate should have been recorded on the books of the newly-organized Corporation B at the par value of the stock issued for it or at what is asserted to be its fair value at date of transfer, one might be tempted immediately to take the easy way out by citing a rule which has frequent application in the case of non-cash transactions.

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, at p. 245) states this rule as follows:

> Property Acquired in Exchange for Company's Stock or Bonds.— As a general rule, cost of property so acquired should be determined either by the fair market value of the consideration given or by the fair market value of the property acquired, whichever is the more clearly evident. When neither is readily determinable, the situation requires careful consideration.
>
> • • •
>
> When stock alone is issued, the par or stated value of the stock usually cannot be relied upon as a reasonable basis for recording the cost of the property acquired. If the fair value of stock is not readily determinable, some appraisal of the property must be made, either by the management or by outside parties, taking into consideration all pertinent factors.

In the case in question, "fair value of the consideration given" appears to be ruled out, since there is no readily determinable market value for the stock of a corporation at the point of being newly-organized. Also, the carrying value of the property on the books of Corporation A just prior to the transfer would not be indicative of fair value unless it represented a recent arms-length purchase price or the results of a competent recent appraisal. If the fair value of the property was less than $62,500 at the time of transfer, then the capital stock of Corporation B was "watered," and the financial statement should have reflected stock discount.

You do state in your letter that Corporation B issued the common and preferred shares "in exchange for a tract of undeveloped real estate having a value of approximately $62,500." However, your first question suggests that you have some lingering doubts respecting the value placed on the books.

You also make reference to the fact that the subsequent distribution of the shares by Corporation A to its stockholders, was a *taxable* spin-off. This naturally raises a number of questions that might have relevance, viz.: whether the real estate transfer qualified as tax-free under IRC section 351 [Transfer to Corporation Controlled by Transferor] even though the subsequent distribution of B shares by Corporation A did not qualify as tax-free under IRC section 368(a)(1)(D) [Divisive Reorganizations, or "Spin-Offs"]. If the transfer of real estate qualified under section 351, then according to our understanding of section 362 [Basis to Corporations], i.e., the general rule respecting property acquired by a corporation in a section 351 transaction set forth therein, the basis of the property in the acquiring corporation's hands is the same basis that the property had in the hands of the transferor. What was the basis of the undeveloped real estate?

These questions, so it seems to us, are quite relevant, for the underlying theory behind sections 351 and 368 (as far as basis provisions are concerned) is that of a *business continuance* or *continuity of beneficial interest*. Squarely, this seems to be your client's case; and in terms of accounting principle, for "substituted basis," one can generally read "adherence to cost." Just as it is generally accepted that assets be carried forward at cost in a business combination, so also, where property is spun off in a divisive reorganization, unexpired costs attributable to the transferred property are generally to be carried forward on the new corporation's books.

In connection with the foregoing remarks, a pertinent excerpt from *Corporate Practice,* by Carlos L. Israels (Practising Law Institute, N.Y., 1963, at p. 93), may well be cited, viz.:

> . . . It is a fairly safe course for directors, confronted with the task of placing a value on property received for shares, to rely upon its cost to the subscriber in a previous arm's-length transaction. If the subscriber insists that the property has increased in value since he acquired it, the board should place upon him the burden of justifying such increase. In cases where there is any doubt, an appraisal by a professional appraiser or other disinterested person should be obtained. However, generally an appraisal is not likely to be as safe a criterion as cost. Once it becomes necessary in valuing property to rely on data other than cost or price in an arm's-length transaction, difficulties increase. Fortunately, in most situations, the necessity does not arise.

Another facet of your question should be mentioned. If the transferred real estate did not get a "stepped-up" basis of $62,500 for Corporation B's tax-reporting purposes, but such value was nevertheless recorded on B's books, then we believe an allowance or offset account measuring the "loss of future tax-deductibility" should be set up against the asset. Query whether the debit setting up the allowance account should, in this case, be reflected as stock discount?

2. In our opinion, for purposes of balance-sheet presentation, it would be unobjectionable to show the units of treasury stock as an unallocated deduction at cost from the net total of preferred and common stock issued, paid-in surplus, and deficit. The respective numbers of preferred and common treasury shares should be parenthetically indicated.

Since it appears there are no reliable market values available for the common and preferred shares, relative market values cannot be used as a basis for allocating unit costs. However, although admittedly they are more or less arbitrary bases, an allocation of unit costs might be based (a) on relative par values, or (b) on the respective amounts to which the preferred and common shares are entitled upon liquidation, i.e., on the respective book values of preferred and common shares. It seems to us that for present and subsequent accounting purposes, some allocation is better than none here; and we are inclined to prefer the latter rather than the former as an allocation basis. (We believe the formula for respective book values would be: par value of issued preferred and common stock plus paid-in surplus less deficit less cost of treasury stock equals net assets; deduct outstanding preferred shares times liquidation value per preferred share from net assets to obtain net assets attributable to outstanding common shares.)

3. Apparently, in contracting for the acquisition of the subsidiary, the parties were agreed that the underlying net book value was a "fair value." Accordingly, we believe the transaction should be accounted for as a purchase, and the investment recorded at the contract price of $12,000 which was equivalent to underlying net book value. If the above-mentioned allocation of the cost of the treasury shares is to be made, we would be inclined to allocate only the net cost, i.e., the residual cost remaining in the Treasury Stock account,

after first crediting such account for $6,000 (480 shs times $12.50) when recording the acquisition of the subsidiary.

Incidentally, it is possible the client violated certain statutory requirements by its purchase of treasury stock at a time when it had already incurred an operating loss of $40,000 – especially if any stock discount attaches to the $62,500 of preferred and common stock issued for the tract of undeveloped real estate. The laws of many states provide that treasury stock may be purchased only when the purchase does not impair legal capital; in some states surplus available for the payment of dividends or other purposes is restricted in the amount of the cost of treasury stock. Such restriction should be disclosed in a note in the financial statements.

Inquiry 445

Acquisition of affiliates' common stock by issuance of preferred stock, with sinking fund requirements for redemption; treatment of excess arising from "purchase"

"Enclosed is an annual report which contains a consolidated balance sheet with two rather peculiar and related amounts.[1]

"Particularly, I cannot understand why on the liability side 'Preferred Stock of a Subsidiary – $5,924,000' is reduced by the excess over underlying book value in an amount of $4,309,989. It appears to me that this might be better classified on the asset side and included with 'Excess of Cost Over Underlying Book Value of Subsidiaries at Acquisition.'

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[1] Too voluminous to publish here. However, the following item appeared on the asset side:

Excess of Cost over Underlying Book Value of Subsidiaries at Acquisition (Notes 2 and 5)	$7,202,597	
Less: Accumulated Amortization	1,075,504	6,127,093

The following item appeared, just above the capital section, on the liability side:

Preferred Stock of a Subsidiary, at par value of $100 per share, net of $150,000 in treasury (Note 6)	$5,924,000	
Less: Excess of par value of preferred stock issued over adjusted underlying book value of affiliated companies acquired in exchange therefor	4,309,989	1,614,011

Footnote 6 reads, in substance, as follows:

(6) Preferred Stock of XYZ, Inc.:

XYZ, Inc. on June 22, 1959, issued 69,996 shares of 3% cumulative preferred stock (authorized 70,000 shares; $100 par value and redemption and liquidation price) in exchange for all of the outstanding common stock of seven affiliated companies. The sinking fund requirements for the redemption of the preferred stock, which must be deposited semiannually beginning April 30, 1960, are based on declining percentages (from 70% for the period to January 31, 1961, to 25% for the periods after July 31, 1962) of XYZ's consolidated net income before Federal income taxes, as defined, in excess of certain specified amounts.

The Certificate of Incorporation of XYZ, Inc., as amended, provided among other things, that the preferred stock acquires sole voting rights of that company if preferred dividends in arrears aggregate $9 per share ($.75 at February 1, 1961), or if sinking fund requirements are not satisfied.

The total redemption price ($5,924,000) of XYZ preferred stock was $4,524,101 in excess of its underlying book value ($1,399,899) as at January 31, 1961.

"Is this one of those types of statements that should be better presented, or do I misunderstand the implication of the titles quoted?"

Our Opinion

We have not undertaken to make an exhaustive analysis of the implications involved in the rather elaborate footnotes to the financial statements in question. Also, since time has been pressing us, we have not contacted the accounting firm to ask them to explain or clarify the presentation of the items referred to in your letter. Accordingly, we will have to give you our own "educated guess" as to what is involved based on a perusal of Footnote 6 of the statements.

It appears to us that when XYZ, Inc. issued approximately 70,000 of its $100 par preferred shares in exchange for all of the outstanding common stock of seven affiliated companies, it may have measured and recorded its investment in such common stock in terms of the par value of the preferred stock. It is a moot question whether the par value of the preferred stock, or the underlying net equity of the affiliates, or some other figure, represented "the more clearly evident" fair value or the best measure of investment "cost," for purposes of this non-cash transaction (i.e., *non-cash only at its inception*). Apparently, the $5,924,000 represents the unredeemed portion of the $6,999,600 of preferred stock initially issued by XYZ, Inc. We further have the impression that the $4,309,989 represents the unamortized excess of the "cost" of XYZ, Inc.'s *investment* (presumably measured by the par value of the preferred) over the underlying net equity of the affiliates at date of acquisition.

Now to the question whether the $4,309,989 item might better have been classified on the asset side and included with "Excess of Cost Over Underlying Book Value of Subsidiaries at Acquisition." Assuming our surmise is correct that the investment in common stocks of affiliates was measured by the par value of the preferred stock issued, then we would answer the foregoing question in the *affirmative only if* it could be demonstrated that the par value of the preferred stock did in fact represent or approximate the best evidence of *cost* of the affiliates' common stock. On the other hand, if the *cost* of such common stock was more nearly approximated by the amount of the underlying net equity, then we would regard the excess in question (i.e., the

$4,309,989) as "watered capital" and would favor the offset presentation under the circumstances, since we would deem the excess to be essentially in the nature of *stock discount.*

All in all, we are inclined to view the issuance of the preferred stock *with binding sinking fund requirements for the redemption of such stock* based on declining percentages of XYZ, Inc.'s consolidated net income before taxes, as an *installment purchase* in effect of the affiliates' common stock. From this standpoint, it would appear that the "Preferred Stock of a Subsidiary" is essentially a long-term liability (the item is reflected outside the capital section), and accordingly, the offset treatment would seem to avoid the amortization of the excess in question against consolidated income while at the same time understating the "liability" by a substantial amount.

Inquiry 446

Allocation of lump-sum price upon purchase of business

"An entire business was purchased for the sum of $50,000. In the contract of sale it was stipulated that the selling price was for fixtures and equipment, and since the sale took place in New York City, a sales tax of $1,500 was paid to the City Collector by the buyer.

"The seller was on the cash basis for accounting as well as tax purposes. The buyer intends to use the accrual basis. Upon taking over the assets of the business, the buyer found that there was $15,000 in accounts receivable. As the accountant for the buyer, I want to place this asset on the books. Would it be proper to credit Capital Stock? If not, what account can I properly credit? I want to set up fixtures and equipment at $50,000."

Our Opinion

Commenting generally, the purpose of stipulating in the contract that the entire selling price is attributable to the fixtures and equipment and paying the city sales tax on the full amount to "make a record" consistent with the stipulation, seems patent, viz., to lay the basis for taking depreciation on the full purchase price for tax purposes. We have some difficulty in understanding how a buyer of "an entire business" would *find* $15,000 in accounts receivable only upon taking over the assets of the business.

In our opinion, the buyer in fact paid $50,000 for receivables, fixtures, and equipment. If the receivables are fully-realizable, they should be reflected on the books at $15,000, and the remaining $35,000 of the contract selling price should be allocated to the fixtures and equipment. As stated at p. 40 of *Accounting Research Bulletin No. 43* (AICPA, 1953):

> A problem arises in cases where . . . a mixed aggregate of tangible and intangible property is acquired for a lump-sum consideration. . . . In these cases, if practicable, there should be an allocation, as between tangible and intangible property, of the cost of the mixed aggregate of property. . . .

The following passage from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 245) is also relevant to the question you raise:

> Property Acquired as Part of a Package. — When a going concern is purchased for a lump sum, it is sound accounting practice to allocate the sum of the amount paid and the liabilities assumed to the various categories of assets acquired. After the amounts allocable to current assets and to liabilities have been determined, the remainder, if any, may be considered to relate to fixed assets and, possibly, to intangible assets acquired. Fixed assets should be appraised, and, if the value so determined is less than the amount assignable to such assets, the difference may be considered to represent cost of intangibles. If the appraisal amount exceeds the balance assignable to the fixed assets, the excess should be deducted from the appraisal amounts, usually on a prorata basis.

Incidentally, unless capital stock were issued in consideration of the assignment or sale of accounts receivable, it would be improper to credit capital stock with the amount of the receivables.

Inquiry 447

Purchase of all stock already outstanding, where "operating rights" constitute sole asset of acquired corporation

"Could we have your opinion on the proper way in which to show a situation on a balance sheet?

"A client purchased all the outstanding capital stock of a corporation for $9,000. The par value of this stock is $10,000. The only assets acquired in the purchase were operating rights. The corporation had no operating records or books of account.

"The client plans to transfer other assets to the corporation he purchased, and commence business. We would appreciate your opinion as to the proper balance-sheet presentation immediately after the purchase and before the transfer of other assets to the corporation."

Our Opinion

Since you state that the client "purchased all the *outstanding* capital stock," we assume that you mean "already outstanding at the time of purchase," and accordingly, that the $9,000 was paid to a third party.

As a matter of principle, if the predecessor owner in an arms-length transaction had paid $10,000 for the operating rights and had thereupon organized the corporation which issued him shares having a par value of $10,000 in consideration of his transferring the rights to the corporation – or if he had paid in $10,000 upon organizing the corporation, and the corporation had later paid out $10,000 for the operating rights – then we see no good reason why in either case, the $10,000 may not now be ascribed to the rights and the rights set up retroactively on the books on that basis.

However, if no past consideration whatever was paid for the rights, to have set them up at $10,000 may have laid the corporation open to the charge that its stock was "watered," possibly on the ground that par value stock must be fully-paid and that the value of the operating rights in question was at that time purely speculative, and accordingly, the rights did not qualify as "property" for the purpose of determining under the applicable corporate statute, whether a valid consideration was paid for the shares issued.

Assuming no *past* consideration (which could be used as a measure of the amount of paid-in capital) was in fact paid for the rights, then it seems to us, in the initial balance sheet, the rights should be set up in terms of the *present* consideration paid to the third party for the stock, i.e., at $9,000, and stock discount reflected at $1,000, to offset the $10,000 of capital stock. The $9,000 which was presumably paid as the result of a "bargained transaction," appears to be the most clearly evident measure of the cost (or value) of the property rights held by the corporation. When additional assets are later transferred to the corporation by the new owner, the stock discount may then be eliminated by crediting $1,000 of the fair value of such transferred assets to the stock discount account.

Addendum

Some accountants might feel that the situation in question is relatively "simple and uncomplicated" and accordingly, that the accounting therefor offers no problem of consequence. However, any such conclusion might prove to be highly superficial and erroneous. There may be much more to this situation than meets the eye, and advice of counsel experienced in the law of the state of incorporation might well be sought.

Not only is there the question whether *sufficient* consideration has been paid into the corporation for the issued stock, i.e., whether a *money value* equivalent to the par value of the issued stock may properly be imputed to the "operating rights," but from another distinguishable standpoint, whether the operating rights transferred to the corporation for stock in the first instance constitute an *adequate* consideration therefor, i.e., whether such rights represent "property" or consideration *of an acceptable type* for the issuance of shares in the particular jurisdiction.

Then, there are the further questions (1) whether the client who purchased the shares could avoid any liability or further assessment for the shares because of his position as *transferee rather than subscriber* of the shares and (2) whether the corporation is organized in one of the relatively few states which allow the issuance of par value shares for a consideration *less than their par value,* in which cases there may be no need to reflect *any* discount.

Also, if *discount* is to be reflected, is it to be reflected at $1,000 on the grounds that the operating rights are consideration of an acceptable type but the value to be imputed should not exceed the $9,000 actually paid therefor in a bargained transaction? Or is it to be reflected at $10,000 on the grounds that the operating rights do not represent consideration (i.e., "property") of an acceptable type for the issuance of shares?

In discussing "Consideration for Which Shares May Be Issued" and statutory provisions generally respecting "fictitious increase of stock" and "issuance of stock fully-paid," Israels and Gorman in their *Corporate Practice* (Practising Law Institute, N.Y., 1962, at pp. 37-8, 41) state the following which might well be pondered, viz.:

> The words "void" and "fictitious," as used in these constitutional or statutory provisions, have been interpreted in various ways. The cases cannot be harmonized. However, it can be stated as a general rule that a bona fide purchaser for value of shares issued in violation of one of these provisions will be protected, but in the hands of any other person such shares are at least voidable.
>
> However, so long as shares issued in violation of a provision of the type discussed remain in the hands of the original holder, a transferee with notice or a donee, they are "watered" and are not "fully paid and nonassessable."
>
> The issuance of "watered stock" is fraudulent in law as against existing shareholders (unless they are estopped by having voted for its issuance) and subsequent bona fide creditors. Both the purchasers of such shares and the directors who voted for their issuance may be personally liable for an unpaid subscription. The measure of that liability varies considerably under the statutes of different states. There is a widespread impression that if par value shares have been issued, the measure of liability for stock watering is only the difference between what is actually paid for the shares and their par value; and that if no-par shares have been issued, liability can be avoided completely. Neither impression is correct. (pp. 37-8)

> The stock watering statutes which impose liability upon subscribers to shares and upon directors who authorize their issuance, often measure that liability by the "inflation" in the balance sheet, i.e., the amount by which the property or services have been overvalued. Accordingly, counsel must take particular care that the directors do not overvalue property or services accepted as consideration for shares *of either type,* and should advise his clients that the fact that overvaluation appears in the surplus account, rather than in the capital stock account, affords no real protection. (p. 41)

INQUIRY: **447**

ACQUISITION FOLLOWED BY LIQUIDATION

Inquiry 448

Liquidation of subsidiary into parent company following initial "purchase" or "pooling of interests"

"This letter is written in response to the Institute's request for comments and/or problems related to intercorporate investments.

"The Interstate Commerce Commission has recently adopted, for certain carriers subject to its economic regulation, the accounting for business combinations recommended in the AICPA's *Accounting Research Bulletin No. 48.* However, many problems, which are perhaps solely related to regulatory work, have arisen in this connection. Some of these which concern a business combination that is deemed a 'purchase,' are as follows:

"1. Motor carrier A purchases all of the stock of motor carrier B. Two years later motor carrier A merges with motor carrier B. In the original purchase agreement, the value of the operating rights of motor carrier B were not specifically stated but were of considerable value to the acquiring carrier and the main reason for the purchase and subsequent merger. QUESTION: At what time should the appraisal of the assets of motor carrier B, particularly the operating rights, be made for purposes of accounting at the time of merger?

"2. Motor carrier A consummates a contract of purchase of motor carrier B and applies to the Commission for approval to buy motor carrier B and its operating rights and to merge. Motor carrier B has valuable operating rights. The approval by the Commission requires from four to six months during which time motor carrier B is operated as a separate entity and either loses or makes profits. QUESTION: For accounting purposes, at which time should the assets and operating rights be appraised, and how should the losses or profits be entered in the books of motor carrier A at the time of the merger?

"3. Motor carrier A purchases all of the stock of motor carrier B. Motor carrier B is to be operated under a definite plan as a separate entity for a period of two or three years and then merged. QUESTION: When should the property be appraised? Should the property accounts of motor carrier B be adjusted to reflect appraisal value of the assets at the date of purchase of the stock?

"4. Motor carrier A purchased all of the stock of motor carrier B ten years ago. Motor carrier B was operated as a separate entity during that time. Motor carrier A now requests merger authority. QUESTION: How should the accounting for the operating rights and present property be accomplished so that the theory of *Bulletin No. 48* may be followed? The Interstate Commerce Commission does not require consolidated statements from carriers which adds to the difficulties of accounting for the subject mergers.

"I am presenting these problems not only for consideration in your study but, since they are current problems with us, I would also like your opinion as to the time of the appraisals and the proper accounting."

Our Opinion

We note that in three of your four questions, you make reference to the *timing of the appraisal* of assets and operating rights of a corporate carrier, in cases where the stock of the latter is initially "purchased," and where, after varying periods of time, the purchased subsidiary is "liquidated into" or merged with the parent carrier. The manner in which your questions are posed suggests that in the several circumstances described, the necessity for an *appraisal* is taken for granted, so that the *timing* thereof becomes the principal problem.

Our personal reaction to the foregoing is as follows: The liquidation of a corporation may quite naturally lead one to thinking in terms of a liquidating distribution of property and the treatment commonly employed *by an individual investor* upon receipt of a liquidating distribution-in-kind. Here, the liquidation and winding up of the corporation is deemed to be an event or occasion warranting the individual investor's determination of either gain or loss on his investment. Thus, the individual investor ordinarily would record a gain or loss measured by the difference between the *fair value* of the liquidating property dividend received and his original investment cost.

Be this as it may, we submit that the liquidation of a corporate subsidiary and its merger into a parent company, is *no less a corporate fusion or pooling* than the common situation where two corporations meet for the first time, so to speak, and pool their net assets. Accordingly, we would take the position that the type of situation in question is not an occasion for appraisal or determination of the "fair value" of the net assets transferred to the parent by the liquidating subsidiary; on the contrary, it is basically a situation in which the net assets of the liquidated subsidiary should be carried forward *at book value, after* appropriate adjustment thereof for any difference between parent's investment cost and book value of the subsidiary's net assets at date of acquisition. The presumption here, of course, is that the carrying values of the subsidiary's assets represent useful residual cost properly to be carried forward into future periods, as a result of the subsidiary's having consistently maintained its accounts in the past in accordance with generally accepted accounting principles.

Thus, we believe the following two general propositions properly state the accounting which should obtain, viz.:

I. When a subsidiary corporation, *the stock of which was acquired under circumstances indicating a "purchase" in the first instance,* is subsequently "liquidated into" or merged with its parent, the accounts of the continuing corporation should be presented essentially as they would be, had the existence of the subsidiary been continued and *consolidated statements* been prepared. As stated at p. 403 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957):

> When there is a merger of a subsidiary with a parent company, or a liquidation of a subsidiary into its parent, it is permissible to include in earned surplus of the parent company the subsidiary's undistributed surplus earned since the date of acquisition by the parent.

II. When a subsidiary corporation, *the stock of which was acquired under circumstances indicating a "pooling of interests" in the first instance,* is subsequently "liquidated into" or merged with its parent, the accounts of the continuing corporation should be presented essentially as they would be, had the existence of the subsidiary been continued and *combined statements* for the pooling been prepared. In the latter case then, the surplus of the subsidiary earned prior to the date of the initial pooling of interests[1] as well as the subsidiary's

[1] Unless it could not be carried forward in whole or in part because the stated capital of the parent corporation *after* the pooling exceeds the total of the stated capitals of the constituent corporations prior to the pooling (see *A.R.B. No. 48,* par. 11 at p. 25).

surplus earned since the date it became a subsidiary, should be carried forward. In this connection, carefully consider par. 10, p. 25, of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957).

To advert to the specific situations set forth in your letter, we have the following comments:

1. Upon merger of subsidiary company B and parent company A, we believe in principle the statements of the continuing corporation should be prepared in precisely the same manner as consolidated statements for companies A and B would be prepared. What would have been consolidated earned surplus (had B been kept alive and a consolidated balance sheet prepared) would now be reflected as the earned surplus of continuing corporation A – such earned surplus would include an amount equivalent to the subsidiary's undistributed surplus earned since the date of acquisition (purchase) by the parent.

Upon merger of subsidiary and parent, there is ordinarily no more need for a new basis for accountability and no more warrant for resort to an appraisal or determination of "fair value," than there is in any other situation where consolidated or combined statements are prepared in regular course. The fundamental guideline is one of adherence to parent's purchase cost as adjusted for increase or decrease in underlying equity of the subsidiary in the interim period between purchase and merger.

Regarding the question of assignment of a portion of the parent's purchase price (investment cost) to operating rights, unless there is evidence that carrier A, in negotiating the purchase price of B's stock, attributed an amount greater than book value to specific *tangible* assets of B, then we would be inclined to allocate any excess of such purchase price over the book value of the underlying net assets of B *at date of acquisition,* to *operating rights,* upon taking B's net assets onto A's books *at date of merger.*

It is important to mention that in a case where the parent company has carried the subsidiary's stock on its books *at cost* during the intervening period and has not been "required" to prepare, and has not in fact prepared, consolidated statements for the fiscal years intervening between stock purchase and merger dates, and the subsidiary, furthermore, has made no direct adjustments on its books to reflect cost of the parent company's investment at acquisition date, it then appears that in taking over the subsidiary's net assets *at merger date,* an adjustment should be made for the *accumulated amortization of any difference* between parent company's investment cost and carrying value of subsidiary's net assets at date of acquisition which (difference) was properly allocable at such date to tangible or intangible assets subject to depreciation or amortization.

For example, if the entire excess over the book value of a subsidiary's net assets paid by a parent in acquiring the subsidiary's stock were, let us say, attributable to operating rights representing a *franchise for a fixed term of years,* adjustment would have to be made at merger date for the accumulated amortization of such excess during the period intervening between acquisition and merger dates.

Another (perhaps more convenient and useful) approach would involve direct adjustment of the subsidiary's assets at date of acquisition so as to reflect the net assets of the subsidiary at the parent company's investment cost. This might involve allocation of a portion of such cost to the intangible operating rights and recording such asset on the subsidiary's books if it had not previously been so reflected.

The parent company might then periodically adjust its investment by taking up on its books currently any income, gains or losses of the subsidiary experienced between acquisition and merger dates. If so, no gain or loss would ordinarily have to be reflected upon substituting the net assets of the subsidiary for the parent company's investment at date of merger (i.e., at date of liquidating the subsidiary into the parent).

However, after initially making the appropriate allocations and adjustments on the subsidiary's books so as to reflect its net assets in terms of the parent company's cost, if thereupon no further adjustments of the parent's investment were made during the intervening two-year period, then, upon merger, it appears the continuing company should reflect a loss or gain measured by the interim change in its underlying net equity.[2]

2. It is not specified here whether the contract involves a purchase of B's stock or a direct purchase of B's net assets. Be that as it may, it appears that the contract negotiated between motor carriers A and B cannot ripen into an actual purchase until the Commission gives its approval; i.e., favorable action by the Commission is a condition pre-

[2] See relevant par's 2 and 10 in chapter 5 of *Accounting Research and Terminology Bulletins* (AICPA, 1961), as well as par's 7, 8, and 19 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959).

cedent to the sale-and-purchase's actually taking effect. Accordingly, in our opinion, motor carrier A should not account for the purchase until the contingency is favorably resolved. Assuming that the contract does *not* provide for upward or downward adjustment of the negotiated contract price for profits or losses incurred during the 4- to 6-month interim period, and that A must bear any interim loss or will gain the advantage of any interim profit, then we believe the accounting should be substantially as indicated under "1" above, *except that* date of final contract negotiation rather than date of ultimate purchase should govern for purposes of measuring the amount to be assigned to the valuable operating rights.[3]

Thus, after Commission approval when either the net assets are taken over or B's stock is obtained followed by immediate liquidation and merger, we believe any excess of contract price over book value of B's net assets *at date of final contract negotiation,* should be assigned to the operating rights and set up on A's books (this assumes no portion of the excess in question is assignable to specific tangible assets of B). Concurrently, the net assets (other than operating rights or excess assigned to operating rights) taken over from B *at date of ultimate purchase,* should be recorded at their book value *as of such date.* Any difference between the contract price (actual cost to A) *and* the sum of (1) excess assigned to operating rights and (2) book value of other net assets taken over, should be treated as a special contract loss or gain.

We recognize that this latter conclusion runs counter to what some, if not most, accountants contend is a generally accepted principle, viz.: "that a profit or loss may not be recognized on a purchase." If this principle is valid, we believe there are extenuating circumstances for not embracing it here; for the foregoing conclusions on our part as to treatment result in taking the net assets of B onto A's books at merger date at a useful and realistic "cost" (i.e., at recently negotiated contract purchase price as adjusted for *loss* with which under the contract the purchaser is necessarily saddled, or *gain* which under the contract necessarily accrues to the purchaser, during the interim

[3] In discussing "Surplus in Mergers, Consolidations, and Acquisitions of Subsidiaries," *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, pp. 402-03) states, in part: "If the effective date specified in an agreement for corporate merger or for purchase of a business is prior to the actual date of passing of title to the properties, it may be practical to consider that the operations of the new (successor) enterprise began on the earlier date. Use of the earlier date is not objectionable if changes in surplus in the interim period are not significant."

period). Actually, if one views the purchase as taking place at date of final contract negotiation and the Commission's favorable action as a ratification, then the interim gain or loss to the underlying net assets becomes merely a post-acquisition gain or loss.

Incidentally, if the contract in this instance provided for upward or downward adjustment of contract price to compensate for gain or loss in the interim period, then no problem of "loss or gain on a purchase" would present itself.

3. Although neither par. 7 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* nor the discussion under the heading "Excess of Cost of Investment in Purchased Subsidiary over Book Amount of Its Net Assets" at p. 478 of *Montgomery's Auditing* (*op.cit.*) make explicit reference to the propriety of *directly adjusting the subsidiary's accounts* when allocating the excess of parent's cost over underlying net equity of subsidiary at date of acquisition, nevertheless, we personally believe such treatment makes good sense and is proper, since actual cost to the parent *in a bargained transaction* is a significant and meaningful figure whether it be for purposes of future preparation of consolidated financial statements or for purposes of combining accounts pursuant to future merger.[4]

Assuming adjustment of the subsidiary's accounts at date of purchase of its stock so as to reflect actual cost to the parent, then it seems to us that *at date of merger* two or three years thereafter (assuming proper interim accounting), the net assets of the subsidiary should be taken over at their book value, and any difference between the parent's investment cost and such book value, should be reflected either as a special charge or credit (loss or gain realized on liquidating subsidiary into parent) or as a material-extraordinary charge or credit to earned surplus.

Alternatively, after direct initial adjustment of the subsidiary's accounts so as to reflect the latter's net assets in terms of actual cost to the parent, the parent company might well follow the procedure of adjusting its investment and "taking up" on its books periodically the net income or loss of the subsidiary during the two or three years prior to merger.

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[4] In his chapter on "Consolidated Statements" in *Contemporary Accounting* (AICPA, 1945, chapter 5, p. 5), Percival Brundage expresses the view that "it is generally preferable to reflect the necessary adjustments in the accounts of the subsidiary company." Also, in this connection, see answers numbers 2 and 4 in the item entitled "Excess of Investment Cost Over Related Subsidiary Book Value" which appeared in Carman G. Blough's column at pp. 486-9 of the June, 1948 issue of *The Journal of Accountancy.*

4. Regarding your fourth case situation, you inquire "how the accounting for the operating rights and present property should be accomplished so that the theory of *Bulletin No. 48* may be followed." We do not find that *A.R.B. No. 48* explicitly discusses the accounting deemed proper when a parent *purchases* the stock of a subsidiary and the latter company after a span of time, merges with, i.e., is liquidated into, the parent company. Our personal view is that liquidation of a purchased subsidiary is an accounting event which may entail recognition of loss or gain on the parent's investment, when the latter has been carried at cost, *but only to the extent* of (a) any increase or decrease in the underlying net equity of the subsidiary in the interim period since date of acquisition by parent, as further adjusted to take into account (b) accumulated amortization of any difference between parent's investment cost and subsidiary's net assets at acquisition date which is attributable to tangible or intangible assets deemed subject to depreciation or amortization accounting.

We believe we have already indicated (see proposition "II" in our fourth paragraph) the relevance of par. 10 of *A.R.B. No. 48* in a situation where a subsidiary is initially acquired by a parent under circumstances which indicate a "pooling of interests" and such subsidiary is subsequently liquidated into the parent.

Inquiry **449**

Amortization of goodwill (or writeoff of loss), upon purchase of stock of carrier, followed by liquidation

"Your opinion on the following question is requested.

"A client of mine is a Class I common motor carrier of property, and as such uses the uniform system of accounts as prescribed by the Interstate Commerce Commission.

"Several years ago this client purchased all the outstanding stock of a competitor and then dissolved the corporation acquired, receiving in exchange for the stock of said corporation all the assets of this corporation. The net tangible assets of this corporation were substantially less than the purchase price, resulting in a charge to goodwill for the difference.

"The Interstate Commerce Commission, as a condition to approval of this acquisition, required that this difference, between net tangible assets and cost of the stock, be charged to account No. 1550 'Goodwill' and that the amount be amortized over a period of 60 months by equal monthly charges to account No. 7500 'Other Deductions.'

"Since the amount involved is substantial and since this is not an income tax deduction, deducting this amount in the income statement resulted last year in showing a net loss before income taxes and an increase in the net loss by the amount of the income taxes.

"My client has requested that I show this item, in my opinion report, not as a deduction in the income statement but rather as a charge to earned surplus.

"Your opinion is requested as to the propriety of showing this charge as a charge to surplus in my report, when it is recorded on the books in account No. 7500, and whether or not this would be a generally accepted accounting procedure."

Our Opinion

Assuming that at the outset there were convincing reasons for setting up as "Goodwill," the difference between the cost of the subsidiary's stock and the carrying value of the subsidiary's net assets at date of liquidation (i.e., assuming that the difference did not represent *a loss to be recognized at date of liquidation* or that the difference was not properly allocable to specific tangible assets at date of acquisition); and assuming further that the amortization procedure was initially adopted and followed in good faith for a number of years for purposes of the company's regular financial reporting as well as its ICC reporting; then in our opinion, it would now be improper to charge the current amortization amount to earned surplus unless the chargeoff were made in connection with a partial or complete writeoff upon a finding that the intangible has become worthless or its term of existence limited.

We believe this conclusion is supported by chapter 5 of *Accounting Research Bulletin No. 43* (AICPA, 1953). Note particularly par's 6 through 9 of chapter 5. Paragraph 6 requires *systematic* amortization possibly accompanied by partial writedown by a charge to surplus in special circumstances, where there is evidence that the term of existence of the intangible has become limited. Paragraph 7 permits discretionary amortization of the cost of an intangible by *systematic* charges against income. Paragraph 8 requires complete writeoff by a charge to income, or if so material as to be distortive, by a direct charge to earned surplus, when it is reasonably evident that intangibles have become worthless. Paragraph 9 proscribes both lump-sum write-offs to earned surplus immediately after acquisition and writeoffs of intangibles to capital surplus in any event. There is "a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income." [See par. 11, chapter 8, of *A.R.B. No. 43*, esp. item "(d)."]

We would give little weight to the fact that the amortization is charged on the books to account No. 7500, *if* we were convinced that a charge to surplus at this time is supported by generally accepted accounting principles, and would make for a fairer presentation. However, we are not so convinced. On the basis of the available facts, it seems to us a surplus charge would be vulnerable on the ground that the entry was dictated by ulterior motives rather than by actual changes in operating conditions. [See first complete par., p. 51, of *Generally Accepted Auditing Standards* (AICPA, 1954).*]

Of course, we are taking your statements at face value, that the client's original acquisition of the stock of the competitor carrier was a "purchase," and not a "pooling of interests." If a "purchase" and, therefore, an *actual cost outlay* is made for the investment (as contrasted with the pooling situation where the company merely issues additional shares of its own stock), then the investing entity, it seems to us, must be prepared to amortize that cost against operations, accepting in full the *burdens* as well as the benefits of its investment decision.

* Cf. *S.A.P. No.* 33 (AICPA, 1963) at pp. 43-4.

Inquiry **450**

Acquisition of stock of corporation followed by merger (liquidation thereof)

"I would like to have an expression of your opinion as to the proper balance-sheet presentation of the excess of net worth of an acquired corporation over the investment therein as carried on the books of the acquiring corporation in a merger of the two, based upon the following at the date of merger:

	Acquired Corp.	*Acquiring Corp.*	*Total*	*Elimination*	*Continuing Corp.*
Capital stock	$1,157,400.00	$ 25,228.60	$1,182,628.60	$(1,157,400.00)	$ 25,228.60
Earned surplus	1,040,523.58	1,378,022.24	2,418,545.82	(675,150.00)	1,743,395.82
Capital surplus		766,290.65	766,290.65		766,290.65
	$2,197,923.58	$2,169,541.49	$4,367,465.07	$(1,832,550.00)	$2,534,915.07
Investment in acquired corp.		$1,832,550.00		$(1,832,550.00)	–0–

"The above presentation results in the elimination of the investment account on the books of the acquiring corporation and the elimination of the net worth of the acquired corporation with the exception of $365,373.58 in earned surplus which is included in earned surplus of the merged corporation.

"Our question is whether the balance sheet of the continuing corporation should be shown as above, without recognition of the gain to the acquiring corporation on the acquisition as a separate transaction, or should the profit to the acquiring corporation, computed as follows, be shown as capital surplus on the continuing corporation's statement:

Market value of net assets (net worth) acquired corporation, at merger date	$2,197,923.58
Investment in acquired corporation	1,832,550.00
	$ 365,373.58

"The facts regarding the nature of the excess of underlying net equity over the cost or carrying value of the investment, are as follows:

1. Purchase price of the stock of the acquired corporation was determined on the basis of the net book value of the underlying assets at December 31, 1957.

2. The purchase was contingent upon the acquisition of 100 per cent of the outstanding stock of the acquired corporation, and certain financing and legal formalities, all of which were not consummated until June 27, 1958.

3. The date of merger was June 30, 1958.

4. The excess of net assets over cost at the merger date was the result of the following:

Net profit of acquired corporation January 1, 1958, through June 30, 1958	$133,406.49
Claims for refund of Federal income taxes for prior years (brought onto books at merger date, June 30, 1958), which are presently in the process of review by the Internal Revenue Service	231,967.09
Excess of book value of acquired corporation over cost of acquiring corporation	$365,373.58

5. The stock of the acquired corporation was obtained in an arms-length transaction for cash.

6. The assets consist mainly of cash or its equivalent, accounts receivable, and inventories, all of which have been verified. The liabilities are all current and small in amount compared to the current assets. The book value of fixed assets is approximately $300,000 at December 31, 1957, and June 30, 1958, so that if the basis of the fixed assets was reduced by the excess of book value over cost, we would have a minus figure. It is our opinion that the value of $300,000 for the fixed assets is conservative."

Our Opinion

Assuming realization of the tax claims in question is reasonably assured (such as claims based on the carryback provisions of the Internal Revenue Code *where the continuing corporation clearly succeeds to* the claims), then at date of the merger, it seems reasonable and proper to take over the assets and liabilities at their respective carrying values on the merged corporation's books, eliminate the cost of the investment, and reflect the $365,364 either as a special credit in the income statement or as a material-extraordinary credit to earned surplus, as circumstances require (see par. 11, chapter 8, *Accounting Research Bulletin No. 43* (AICPA, 1953).

We would be inclined to disclose, in a footnote to the financial statements, the nature of the items comprising the excess of net assets over cost at the merger date.

Of course, if realization of the claims for refund of Federal income taxes is not reasonably assured, such claims should not be carried over and reflected on the books of the continuing corporation. In this connection, note the statement at p. 91 of *A.R.B. No. 43*, viz.:

> *While claims for refund of income taxes ordinarily should not be included in the accounts prior to approval by the taxing authorities,* a claim based on the carry-back provisions of the Internal Revenue Code presumably has as definite a basis as has the computation of income taxes for the year. Therefore, amounts of income taxes paid in prior years which are refundable to the taxpayer as the result of the carry-back of losses . . . ordinarily should be included in the income statement of the year in which the loss occurs . . . (*our emphasis*)

Old *A.R.B. No. 23* stated at p. 192 that "claims for refunds based on the carryback provisions of the law may be shown as current assets if collection is reasonably assured."

If as a practical matter, the date as of which the purchase price of the stock was *determined* is deemed to be the date of purchase (even though the purchase was contingent at such date), then the interim profit of the subsidiary to date of merger may be viewed as post-acquisition earnings. Even if the carryback claim is characterized as a "profit on a purchase" since the acquiring company never did have to pay for it, assuming the claim is reasonably assured, we then think there are extenuating circumstances here for recognizing this windfall.

Inquiry **451**

Acquisition of subsidiary (partly with funds loaned by subsidiary) followed by its liquidation six months later

"The following facts are presented as a basis for your consideration in answering the question stated below:

"A company was formed (with capital of $40,000) for the purpose of buying another company with earned surplus of $90,000 and capital of $10,000. The transaction was consummated in October, 1958, for $125,000 – the difference between net book value and purchase price being attributable to fixed assets. Funds with which to buy the stock were obtained from the original cash capital contributed and from an $85,000 loan from the subsidiary. The subsidiary company earned a $30,000 profit during the year, but incurred a loss between acquisition and the end of its fiscal year (December 31, 1958).

"In March, 1959, the subsidiary was liquidated, and the assets and liabilities assumed by the parent. The excess of the purchase price over the net book value at date of acquisition was allocated to the fixed assets. The subsidiary earned a $22,000 profit from January 1, 1959, to March 31, 1959. However, due to the operating loss sustained between date of acquisition and the end of the fiscal year, there was an over-all decrease of $2,000 in net book value.

"The question is: What is the proper method of handling this decrease in net worth? The investment is kept on the cost basis and no dividends were paid by the subsidiary."

Our Opinion

We visualize the situation just after the new Corporation A was organized, as follows:

CORPORATION A

Assets		*Liabilities*	
Cash	$40,000	Capital Stock	$40,000

CORPORATION B

Assets		*Liabilities*	
Cash	$85,000	Capital Stock	$10,000
Inventory	5,000	Earned Surplus	90,000
Fixed Assets	10,000		

After consummation of "the transaction," the balance sheets should appear as follows:

CORPORATION A

Assets		*Liabilities*	
Investment in B	$125,000	Loan Payable to B	$85,000
		Capital Stock	40,000

CORPORATION B

Assets		*Liabilities*	
Loan Receivable from A	$85,000	Capital Stock	$10,000
Inventory	5,000	Earned Surplus	90,000
Fixed Assets	10,000		

Assume that Corporation B sold off its inventory for $3,000 cash, incurring a $2,000 loss thereon. Therefore, just prior to liquidation, Corporation B's balance sheet would appear as follows:

Assets		*Liabilities*	
Cash	$ 3,000	Capital Stock	$10,000
Loan Receivable from A	85,000	Earned Surplus	88,000
Fixed Assets	10,000		
	$98,000		$98,000

Assume that, between acquisition and liquidation date, Corporation A was inactive.

Entries upon liquidation at March 31, 1959:

B's books — Reversal of all balances in above balance sheet.

A's books —	*Dr.* Loan Payable to B	$85,000	
	Fixed Assets	35,000	
	Cash	3,000	
	Deficit	2,000	
	Cr. Investment in B		$125,000

Continuing Corporation A's balance sheet would then appear as follows:

CORPORATION A

Assets		*Liabilities*	
Cash	$ 3,000	Capital Stock	$40,000
Fixed Assets	35,000	Deficit	(2,000)

By way of understatement, it seems highly "unconventional" for a corporation to lend money to another corporation for the purpose of the latter's purchasing the lending corporation's own stock. Accordingly, one might conclude that the loan was one ploy in a step transaction looking toward the retiring stockholder's getting his money out of Corporation B via Corporation A at capital gain rates. The transaction appears to be a variation of what has been referred to in some of the "smart" tax literature as the "liquidation-reincorporation bailout gambit."

However, if we can assume for the moment that, vis-à-vis the organizers of Corporation A, said retiring stockholder was, nevertheless, a bona fide third party who had fixed assets to sell, and the parties to the transaction mutually agreed that the fair value of such assets exceeded their carrying value on Corporation B's books by $25,000, then we believe Corporation A did in fact *purchase* assets in an arm's-length transaction, and may properly reflect the $25,000 increment as part of the cost of such assets, upon liquidation of Corporation B. The final balance sheet pictured above is predicated on the foregoing assumed circumstances.

On the other hand, if we were to assume that Corporation A and B were *commonly-controlled,* then, of course, there would have been no bargained price for the fixed assets, the person in common control would have a continuing beneficial interest in the assets both before and after the liquidation, and thus the $25,000 should not be imputed to the fixed assets upon liquidation. The residual cost of the assets on Corporation B's books should be carried forward on A's books. To do otherwise would result in a disguised upward departure from cost. Thus, on liquidation, we believe the $25,000 excess should be charged to the deficit account as a distribution of Corporation A's capital. This delayed accounting recognition of the original payout as a distribution would then bring us full circle.

INQUIRY: **451**

Inquiry 452

Excess purchase price of investment over underlying book value, upon liquidation of subsidiary

"We have a problem concerning the accounting treatment of the excess of purchase price of a subsidiary over book value upon liquidation of the subsidiary.

1. Corporation A purchased in January, 1958, a 100 per cent interest in Corporation R at a price which was $20,000 in excess of the book value.
2. The assets of the subsidiary (Corporation R) consisted of cash and contracts receivable with an approximate maturity of 60 months.
3. The parent company (Corporation A) liquidated the subsidiary in June, 1959.
4. The assets of the subsidiary (Corporation R) were transferred to, and the liabilities assumed by, the parent company (Corporation A).
5. The excess of $20,000 was paid to gain quick entry into another business. The acquired corporation is a relatively new one. It had not made any profits before acquisition nor have there been any since acquisition.
6. Another reason for acquisition was to gain a favorable bank connection.
7. There has been no amortization of the 'excess' to date.
8. The consolidated retained earnings are $150,000.

"We would appreciate having your opinion as to the preferred accounting treatment of the excess of purchase price of the subsidiary over book value upon liquidation of the subsidiary."

Our Opinion

We assume in the case in question that Corporation A paid cash for its 100 per cent interest in Corporation R, thus eliminating the old management interest in R.

We would like to think in this case that the investment by Corporation A in January, 1958, was *prudently* made, and that the $20,000 excess of purchase price over book value of underlying net assets may properly, upon liquidation, be set up as purchased Goodwill. The assets and liabilities taken over from R could then be carried forward at their previously-recorded book values, assuming no adjustments of such carrying values were deemed necessary.

However, we have some difficulty under the circumstances described, in imputing the excess in question to Goodwill. You state that the excess was paid to gain a quick entry into another business, that the acquired corporation is a relatively new one, that it had not made any profits before acquisition nor have there been any since acquisition, and that another reason for acquisition was to gain a favorable bank connection. In our view, all of this does not add up to the usual conception of Goodwill. Goodwill, if it means anything, has reference to a mature and tested business characterized by superprofits, or at least a stable and proved earning performance. Accordingly, we are inclined to conclude here that the $20,000 excess in question is not a useful cost and should be charged off as a loss.

One further question not determinable on the basis of the information contained in your letter, arises: whether one of the assets carried on the books of the subsidiary, namely, "contracts receivable with an approximate maturity of 60 months," is an admissible or recognizable asset in accordance with generally accepted accounting principles. This in our opinion, would depend on whether the amount of "contracts receivable" represents actual earned income resulting from performance of the contracts *or* prospective revenue, recognition and realization of which is contingent on the running of a time period (as in the case of future rentals to be received under leases) or on future performance of the contracts in question.

Inquiry **453**

Purchase of 100 per cent of another corporation's stock followed by dissolution of acquired corporation within the year

"We would sincerely appreciate your suggestions concerning the financial statement presentation in the following situation:

"X Company is a drilling contractor on a calendar-year basis. In February they paid in $3,000 for 75 per cent of Y Company. The remaining 25 per cent was paid in by an outsider. In November of the same year, X Company acquired the 25 per cent interest from the outsider for $10,000. At this time the company had a small net loss. On the last day of the year, X Company (then owning 100 per cent of the stock of Y Company) dissolved Y Company.

"We would appreciate your opinion regarding the following questions:

"1. How should the $9,000 premium paid the outsider for his minority interest be treated in the balance sheet of X Company?

"2. Can the income statement of X Company and Y Company be combined for the year? If so, should the minority interest be reflected, in any way, in the combined income statement?

"3. Assuming that the income statements of the two companies can be combined and assuming that the minority interest would not be reflected as it did not share in the income due to selling their stock to X Company, what type of note would be appropriate to describe this combined statement of income?

"4. Would the balance sheet require a footnote or designation as a combined statement due to the fact that it was in effect one company at the year-end, even though the profits for the year were not those of one company?"

Our Opinion

Generally, we speak of preparing consolidated financial statements or "combined" financial statements as the case may be only when there is direct intercorporate ownership and control *or* common control of the constituent corporations at the end of the fiscal period in question. Since Y Company was no longer in existence at the end of the fiscal period, we do not believe the situation outlined in your letter is one in which we would specifically *label* the financials prepared at the year-end as "combined statements." However, as we view it, the balance sheet prepared for X Company at the year-end should be essentially the same *as it would have been* had Y Company continued in existence and had a consolidated balance sheet for X and Y *properly* been prepared. By "properly," we have particular reference here to the treatment that should be accorded the excess of X Company's investment over the book value of Y Company's net assets.

The X Company made a total investment of $13,000 in Y Company and later liquidated the Y Company into X Company — all within the same fiscal year. The difference between the book value of the net assets taken over upon dissolution of Y Company and the $13,000 would appear to measure the amount of an incurred loss. We see nothing in the premises justifying treatment of the "$9,000 premium paid the outsider for his minority interest" as Goodwill; and unless in the interim between formation of Y Company in February and acquisition of the 25 per cent interest from the outsider in November, *proven* mineral lands or other valuable rights were acquired, it does not appear that the $9,000 excess payment may properly be carried forward in X Company's statements as useful cost. Such loss should be shown as a special charge in the income statement of Company X, or if deemed material in amount (when taken as a percentage of average operating results), should be charged directly to earned surplus in accordance with par. 11, p. 63, of *Accounting Research Bulletin No. 43* (AICPA, 1953).

COMMON-CONTROL SITUATIONS

Inquiry 454

Merger of closely-held, family-owned corporations — treatment as "pooling"

"The following is submitted in connection with our request for advice as to the accounting treatment to be followed with regard to a statutory merger of two of our clients.

"Corporation A is incorporated under the laws of the state of Florida. Its balance sheet (unconsolidated; subsidiaries carried at cost of investment) at June 30, 1962, reflected:

Assets $4,760,000

Liabilities	$1,325,348
7500 Shares Cumulative Pfd., $100.00 Par	750,000
4228 Shares Cumulative Convertible Pfd., $100.00 Par	422,800
7852 Shares Common, $1.00 Par	7,852
Surplus	2,254,000
	$4,760,000

"Corporation B was incorporated under the laws of the state of Florida. Its balance sheet (no subsidiaries) at June 30, 1962, reflected:

Assets $5,090,000	
Liabilities	$1,593,419
19,675 Shares Cumulative Pfd., $100.00 Par	1,967,500
2819 Shares Cumulative Convertible Pfd., $100.00 Par	281,900
5181 Shares Common, $1.00 Par	5,181
Surplus	1,242,000
	$5,090,000

"The stock of Corporation A was held, as follows:

	Shares		
	Cumulative Convertible Preferred	*Cumulative Preferred*	*Common*
In trust for Mrs. D (mother of F & J)		7500	
Brother F			3506
Brother J			3926
In trust for F & J	4228		
Outsiders (purchased from F on June 29, 1962)			420

"The stock of Corporation B was held, as follows:

	Shares		
	Cumulative Convertible Preferred	*Cumulative Preferred*	*Common*
In trust for Mrs. D		11935	
Brother F		5975	
Mrs. D		120	
Outsiders		1645	
In trust for F & J	2819		
Brother J			5181

"On July 2, 1962, at 9:00 a.m., Corporation B was merged into Corporation A, in a statutory merger, under the laws of Florida, Corporation A surviving. In accordance with a change in the Articles of Incorporation, A stock was issued as follows:

STOCKHOLDER	STOCK PREVIOUSLY HELD	STOCK RECEIVED AFTER MERGER
Trust for Mrs. D	B – 11935 Cum. Pfd.	A – 11935 Cum. Pfd.
Trust for Mrs. D	A – 7500 Cum. Pfd.	A – 7500 Cum. Pfd.
Trust for F & J	B – 2819 Cum. Conv. Pfd.	A – 2819 Cum. Conv. Pfd. #2
Trust for F & J	A – 4228 Cum. Conv. Pfd.	A – 4228 Cum. Conv. Pfd. #1
F	B – 5975 Cum. Pfd.	A – 5975 Cum. Pfd.
F	A – 3506 Common	A – 3506 Common #2
J	B – 5181 Common	A – 2591 Common #2
J	A – 3926 Common	A – 3926 Common
Mrs. D	B – 120 Cum. Pfd.	A – 120 Cum. Pfd.
Outsiders	B – 1645 Cum. Pfd.	A – 1645 Cum. Pfd.
Outsiders	A – 420 Common	A – 420 Common #2

"It should be noted that Common #2 is the voting stock.

"On July 11, 1962, Company A borrowed $2,000,000 and on that date purchased from F his 3506 shares of Common #2, placing the shares in Treasury.

"It is the intent of the parties at interest that this statutory merger be treated as a 'pooling of interests.' It is our feeling that this transaction so qualifies in all material circumstances but possibly that of the change in ownership through the purchase of the Common #2 shares of F. All the shares, with the exception of the B Common, were exchanged on a share for share basis, and voting rights remained the same; continuity of business enterprise remains; actual management of business enterprise remains unchanged.

"Militating against the possibility of disqualification as a 'pooling of interests,' by virtue of the change of ownership, is the fact that the common stock of Corporation A was held in a Voting Trust (created through an agreement, entered into on March 15, 1958, between J, F and Mrs. D) with J as voting trustee during his lifetime, with the right to designate a majority of the board of directors of Corporation A. Therefore, control of both A and B vested in J, both prior to and subsequent to the merger of B into A. This would seem to meet the spirit of *Accounting Research Bulletin No. 48*, paragraph 5, if not the exact letter of same."

INQUIRY: **454**

Our Opinion

We have considered the facts as outlined in your letter in the light of the criteria for a "purchase" and "pooling of interests" set forth in *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), and in our opinion, the merger transaction may properly be deemed a "pooling of interests" for accounting purposes.

The only language we find in the *Bulletin* which might raise a question as to the propriety of the pooling treatment is the following, par. 5, viz.:

> ... When the shares of stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessor, a new ownership or purchase of the predecessor is presumed to result. . . . Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase.

The foregoing language when interpreted literally apparently presents quite a "hurdle" to treatment of the transaction as a "pooling." However, with reference to the first-quoted sentence, there is no conclusive presumption to be raised. What is more important, we do not believe the quoted language was ever intended to be construed so as to apply to a situation in which prior to the business combination, there is common voting control of the corporate constituents by a person who after the combination, retains the voting control. Stated differently, we feel that the controlling consideration here is the fact that not only is there a continuity as to the nature and functions of the business but also a continuity of management and the power to control management.

Moreover, we see nothing in the facts and premises as outlined which would suggest the desirability of, let alone *warrant*, a new basis of accountability for the assets of the fused, family-controlled corporations.

Inquiry **455**

Donating stock of one commonly-controlled corporation to another commonly-controlled corporation — treatment as "pooling"

"We should appreciate your guidance with respect to the proper method of statement presentation in connection with our unqualified certification of an audit report on a consolidated basis. The question revolves around the issue as to whether or not the donation of capital stock would constitute paid-in surplus or retained earnings.

"The outstanding shares of stock are owned by two family interests, one group owning 60 per cent and the remainder 40 per cent. The interest of the members of each family in each of the two corporations is different but each family group owns 60 per cent and 40 per cent respectively of Corporations A and B. Specimen copies of the condensed balance sheets prior to consolidation follow for your guidance. You will note that the balance sheets are dated June 30, and we desire to prepare a consolidated report as of the beginning of business on July 1, 1960.

"As of July 1, 1960, the shareholders of Corporation B have donated their capital stock to Corporation A thereby making Corporation B a wholly-owned subsidiary of Corporation A. For statement presentation purposes, would the retained earnings of Corporation B on a consolidated basis be considered as retained earnings or as paid-in surplus?

"For your further information, it is the intention of the shareholders and board of directors of Corporation A to adopt a plan of liquidation of Corporation B in September, 1960, thereby converting Corporation A's investment in the wholly-owned subsidiary to the actual assets acquired."

Our Opinion

In our opinion, the situation outlined in your letter meets all the principal criteria of a "pooling of interests" as that term is defined and discussed in *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), and should be accounted for as such when preparing consolidated or combined statements prior to actual liquidation of Corporation B. In *A.R.B. No. 48,* see especially for its relevance to your problem, par. 4, the first two sentences of par. 9, and the third and fifth sentences of par. 11.

"A" COMPANY
(A PENNSYLVANIA CORPORATION)
Balance Sheet – June 30, 1960

CURRENT ASSETS	$1,700,000	CURRENT LIABILITIES (Includes Accounts Payable—"B" Company $50,000)	$1,900,000
PLANT, PROPERTY AND EQUIPMENT—NET	700,000	LONG-TERM LIABILITY	450,000
		CAPITAL STOCK—$10.00 Par Value—Authorized 20,000—Issued and Outstanding 10,000 Shares	100,000
OTHER ASSETS	100,000	RETAINED EARNINGS	50,000
	$2,500,000		$2,500,000

"B" COMPANY
(A NEW YORK CORPORATION)
Balance Sheet – June 30, 1960

CURRENT ASSETS		CURRENT LIABILITIES	$ 200
Cash	$ 1,000	CAPITAL – Common Stock – No Par Value – Authorized, Issued and Outstanding 100 Shares	1,000
Accounts Receivable – Trade	30,000		
Accounts Receivable – "A" Company	50,000	RETAINED EARNINGS	79,800
	$81,000		$81,000

Accordingly, when the Corporation B stock is donated or transferred to Corporation A, it seems to us an appropriate entry on the latter's books would be:

Dr. Investment in Stock of Subsidiary B	$80,800	
Cr. Capital Surplus		$ 1,000
Undistributed Earnings of Subsidiary B		$79,800

We would use the book value of Corporation B's net assets rather than an estimated fair value for the donated stock because in a pooling, "a new basis of accountability does not arise."

Then, for purposes of the consolidated or combined statements as of July 1, 1960, i.e., prior to actual liquidation of Corporation B, we believe a proper financial presentation of the "pooling" would be achieved if the following eliminating or consolidating entry were made:

Dr. Corporation B Common Stock	$ 1,000	
Undistributed Earnings of Subsidiary B	79,800	
Cr. Investment in Stock of Subsidiary B		$80,800

The net worth section of the consolidated or combined balance sheet would then reflect $100,000 of capital stock, $1,000 of capital surplus, and $129,800 of combined or "pooled" retained earnings. Possibly you may wish to disclose in a footnote the portion of the combined retained earnings ($79,800) which technically represents undistributed earnings of Subsidiary B.

Inquiry **456**

Parent company's acquisition of subsidiary's stock by donation

"This inquiry concerns the bulletin on Consolidated Financial Statements issued by the Committee on Accounting Procedure. In its bulletin the Committee stated its recommendations with regard to the purchase of a subsidiary's stock by parent company. It did not discuss the same situation when the parent company acquires the stock of a subsidiary by the *donation* of the subsidiary's stock to the parent.

"Specifically, what treatment should be accorded the earned surplus of the subsidiary on the consolidated financial statement? Would it be proper to show this amount as capital surplus on the consolidated financial statement?

"Also, would it be proper to show the investment on the books of the parent company at the par value of the donated stock plus the earned surplus of the subsidiary at the time of the donation?

"If there have been any pronouncements by any committee of the Institute relative to this situation, we would appreciate being referred to them. If there have been no such pronouncements, we would appreciate a recommendation as to the proper procedure for handling such a situation."

Our Opinion

Assuming a run-of-the-mill donative situation *where donor and donee are not affiliated or related entities* prior to the donation, "cost" of the donated asset for subsequent accounting purposes is generally deemed to be fair market value at the date of acquisition. Thus, in our opinion, the parent company referred to in your letter should, in the absence of a "pooling of interests" characterized by a continuance of beneficial interest, record the investment on its books at fair market value. Any difference between the fair market value of the investment as recorded by the parent and the book value of the underlying net equity of the subsidiary should, in our opinion, be allocated to specific tangible and intangible assets of the subsidiary. We would be inclined to make this allocation by actual writeup or writedown, whichever required, on the books of the subsidiary. Donated surplus equivalent in amount to the recorded fair value of the parent's eliminated investment, would appear in a consolidated balance sheet subsequently prepared. The assets, liabilities, and net worth accounts reflected in the consolidated balance sheet would, as we visualize it, be the same as those that would have appeared on the parent's balance sheet if the net assets of the subsidiary had been physically donated and transferred to the parent rather than stock, giving control over the net assets.

As we see it, there would be a pooling of interests in a situation of this kind if the donor prior to transfer of the subsidiary's stock had *common control* of both subsidiary and parent companies.

In such a circumstance, we believe an exception to the general rule that donated assets be recorded at fair market value, should be made, to require that the parent's investment be recorded at the par or stated value of the subsidiary's stock. The entire earned surplus of the subsidiary, both pre-pooling and post-pooling portions, as well as the book values of the subsidiary's net assets, could then be carried forward in a consolidated balance sheet subsequently prepared. Donated or capital surplus equivalent in amount to the par or stated value of the subsidiary's stock, would be included in the consolidated or combined balance sheet. Since the stated capital of the combined entity is less than the combined stated capitals of the constituent corporations, the difference should appear in the combined balance sheet as other contributed capital. [See par. 11 of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957).]

Absent a pooling, we believe it would be theoretically proper to record the investment on the parent's books at book value of the underlying net equity of the subsidiary only if such book value was deemed to approximate fair market value.

Inquiry 457

Purchase, pooling, or dividend? — where one of several commonly-controlled corporations acquires stock of others, for cash

"Five corporations are in existence. All of the outstanding capital stock of each corporation is owned by one individual, who operates and manages each corporation. All corporations are engaged in complementary activities. At a time when the capital stock of four of the corporations is stated at $11,000 and the retained earnings of these four corporations is $3,000, the fifth corporation acquires the outstanding stock of the previously-mentioned four corporations for $29,000 cash. At this time, the previously-mentioned individual is still 100 per cent in control of all five corporations.

"The question arises as to whether or not there is any justification for treating this combination as a 'pooling of interests' rather than as a 'purchase.'

"Eliminating the question of relative size, it would seem that the basic factors necessary for a pooling treatment are present, viz.: continuity of management, ownership, and control.

"In our opinion, it would seem that the transaction is a 'purchase.' However, we would appreciate any thought you might have on the subject."

Our Opinion

With reference to the fact situation and problem set forth in your letter, our opinion is that the described transaction qualifies *neither* as a "purchase" (weighty considerations here being the absence of arms-length dealing and the fact that ultimate control of the assets transferred has not changed) *nor* as a "pooling of interests" (no exchange of stock for stock being involved). We personally conclude under the circumstances, that the $29,000 payout of cash should be construed as a *dividend.*

Thus, we believe that when the fifth corporation acquires the stock of the other four corporations, it should charge earned surplus $29,000 and record its "investment" in the stock of the other four corporations at *zero.* One cannot have a "bargained transaction" with one's self. When preparing consolidated-combined statements for the new parent and four subsidiaries, capital stock of the subsidiaries would be debited $11,000 and capital surplus credited with the same amount. The $3,000 earned surplus of the subsidiaries would be combined with the remaining earned surplus of the parent company and carried forward as such.

Inquiry 458

Pooling of corporations commonly-controlled at inception of series of transactions, involving partial elimination or redemption of beneficial interests

"Could we have an informal opinion from you as to the application of generally accepted accounting principles to the following situation?

"Three shareholders, A, B and C, each own one-third of the shares of Corporation M and Corporation S. A and B sell their Corporation M stock to C. C donates 14 per cent of the outstanding stock of Corporation S to a charity, and donates 19-1/3 per cent of the stock of S to Corporation M as donated capital. Shortly thereafter, M buys from A, B and the Charity all the shares of S owned by them. M then liquidates S. The assets of S consist principally of a mortgage loan service portfolio and some tangible assets.

"In the above situation, immediately after the donation of S stock to M by C, is the net worth of M to be considered increased by the fair market value of the stock donated?

"Immediately after M liquidates S, would the sum of fair market value determined above for the donated shares of S, plus the cost of the purchased shares of S, be allocated to the assets of S received by M from the liquidation?

"If the servicing portfolio is determined to have a limited useful economic life of, say, seven years, should it be written off over seven years with current profit and loss and donated capital each being charged in proportion to the relative amounts of the cost of purchased shares of S and the market value (at time of donation) of the donated shares of S?"

Our Opinion

We have carefully considered your statement of the facts, and in our opinion, a *critical* choice has to be made at the outset between two accounting approaches producing basically different results. It seems to us the transaction or series of transactions described does not comfortably fit into a conventional mold to which "generally accepted accounting principles" may automatically be applied.

1. Should the problem be approached solely from the standpoint of *separate entity M's* accounting *piecemeal* for several *separate* transactions? Should the acquisition of the stock be viewed as a direct purchase of "another corporation's" stock which, upon liquidation, amounts substantially to a purchase of a portfolio (intangible)?
2. Or should a "pooling" or combined entity approach be used? Should the series of transactions be viewed as a related whole and the over-all economic result or effect be appraised? Should "fair values" be introduced into the accounts, or costs carried forward?

Our personal conclusion is that the situation is basically a pooling of businesses involving a partial elimination (a redemption if you will) of beneficial interests. Stated differently, we believe a "capital transaction" from a combined-entity standpoint, is involved.

Let us assume some figures to see how the rationale under "1" and under "2" above, would work out:

Corporation M (at outset)

Assets	$1,000,000	$ 200,000	Liabilities
		210,000	Capital Stock
		590,000	Earned Surplus
		$1,000,000	

Corporation S (at outset)

Assets	$ 100,000	$ 70,000	Liabilities
		15,000	Capital Stock
		15,000	Earned Surplus
		$100,000	

Assume, for the examples which follow, that the amount of cash paid by M to A, B, and the Charity in exchange for S's stock totals $250,000.

Following the rationale under "1", viz.:

Corporation M (after $250,000 payout but before liquidation)

Other Assets	$ 750,000	$ 200,000	Liabilities
Investment in S	255,000*	210,000	Capital Stock
		5,000	Donated Capital**
		590,000	Earned Surplus
	$1,005,000	$1,005,000	

*Measures $250,000 payment for stock plus "cost" of $5,000 assigned to stock donated by C.
**Booked at amount of C's original capital contribution to S.

Corporation M (after liquidation)

Other Assets	$ 750,000	$ 200,000	Liabilities
Assets previously recorded by, and acquired from, S	100,000	70,000	Liabilities of S assumed by M
		210,000	Capital Stock
Mortgage Loan Servicing Portfolio	225,000	5,000	Donated Capital
		590,000	Earned Surplus
	$1,075,000	$1,075,000	

Following the rationale under "2" whereby combined statements[1] for Corporations M and S (which were commonly-controlled prior to C's purchase of M stock from A and B) are prepared at the outset,

[1] Regarding the propriety of preparing Combined Statements for commonly-controlled corporations, see *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959, par's 22 and 23 at p. 48). In the article entitled "Some Problems Regarding Consolidated and Parent Company Statements" in *The Journal of Accountancy* for November, 1953, pp. 570-6, see also question and answer 7 at p. 573.

and all transactions thereafter viewed strictly from the standpoint of the combined entity, viz.:

Combined Statement of
Corporations M and S (before $250,000 payout)*

Assets	$1,100,000	$ 270,000	Liabilities
		225,000	Capital Stock
		–0–	Treasury Stock
		605,000	Earned Surplus
	$1,100,000	$1,100,000	

Combined Statement of
Corporations M and S (after $250,000 payout)*

Assets	$ 850,000	$ 270,000	Liabilities
		210,000	Capital Stock
		370,000	Earned Surplus
	$ 850,000	$ 850,000	

*From a combined-entity standpoint, this "payout" may be viewed as a distribution in partial liquidation or as a partial redemption and retirement of stock.

From a combined-entity standpoint, we personally feel that there has been no "purchase" of an intangible – the portfolio was an asset of the combined entity at the outset and remains an asset of the combined entity upon culmination of the series of transactions – an *unrecorded* intangible to be sure, either because no outlay *to a third party not having a beneficial stock interest in the combined entity* was ever made therefor, or if made in the past, expenditures therefor had been expensed.

Regarding your statement of the facts, we note that no values are specified. Also, there is no indication whether the charity is independent or family-sponsored. We note further that no information is set forth as to who A and B are, i.e., whether they are family-connected or non-family-connected individuals, *or* two other corporations owned wholly or in part by C, *or* corporations owned by other affiliated parties, *or* some other possibility. Knowledge of the foregoing *might,* and then again it *might not,* affect one's appraisal of the arm's-length features of the transactions – or should we say, series of related transactions?

As a matter of Institute policy, we cannot undertake to discuss tax aspects of inquiries submitted. However, we urge you to study carefully pp. 124-30 of Stanley and Kilcullen's *The Federal Income Tax – A Guide to the Law* (Tax Club Press, Tucson, Ariz., 1961) discussing redemptions of stock. See especially the discussion of Section 304 (Redemption Through Use of Related Corporations) at pp. 129-30. The following statement would appear to have some relevance, viz.:

> In addition, Sec. 304(a)(1) provides a similar rule for "brother-sister" corporations. Where the same person or persons control two corporations and sell the stock of one corporation to the other, the proceeds of sale are treated as an amount distributed in redemption of the stock of the acquiring corporation.

"SPIN-OFFS" OR BUSINESS SEPARATIONS

Inquiry 459

Accounting aspects of corporate "spin-off"

The following was written in response to an Institute member's request for references we might be able to provide, or commentary we might care to make, on the *accounting* aspects of corporate spin-offs.

Our Opinion

Perhaps we should preface this by stating that Kohler in his *A Dictionary for Accountants* (Prentice-Hall, Inc., N.Y., 1963, at p. 453) defines a "spinoff" as "The transfer by a corporation of a portion of its assets to a newly formed corporation in exchange for the latter's capital stock which is thereupon distributed *as a property dividend* to the stockholders of the first corporation" (*our emphasis*).

Although a great deal has been written on the *tax* aspects of "spin-offs," at this writing we have been able to find only two references dealing with the *accounting* for "spin-offs," "divisive reorganizations," or (to use an atomic-age term) "corporate fission," namely, an excellent article entitled "Business Separations," by Weldon Powell, which appeared in the March, 1957 issue of *The Journal of Accountancy* (q.v.); and *Accounting for Business Separations,* by William Hammond Culp (Ph.D. Dissertation, U. of Michigan, 1960; reprint available from University Microfilms, Inc., Ann Arbor, Michigan).

We offer the following comments:

1. Perhaps the first point we should stress is that, although an allocation of earnings and profits is required in these situations for tax purposes,[1] there is no explicit recommendation or requirement in any of the Institute's bulletins that allocated portions of the transferor corporation's earned surplus be carried forward in the respective accounts of the newly-formed transferee corporation and transferor corporation.

However, the following key sentences of par. 9 of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957) will be recalled, viz.:

> When a combination is deemed to be a pooling of interests, *a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations,* if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, *should be carried forward;* and *the combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward,* except to the extent otherwise required by law or appropriate corporate action. (*our emphasis* — note that the language of the *Bulletin* is *mandatory; not permissive* as some writers on the "pooling of interests" have contended.)

By the same logic applied to the reverse situation, it would appear that earned surplus should be allocated and carried forward, if feasible, in the case of what might be called a "segregation of interests,"

[1] A "Spinoff" is a Clause D reorganization as defined in section 368(a)(1) of the Internal Revenue Code. In Stanley and Kilcullen's *The Federal Income Tax — A Guide to the Law* (Tax Club Press, N.Y., 1955), see the discussion at pp. 170-2.

i.e., the spin-off. This assumes, of course, a *continuity of the same ownership or beneficial interest in the separate corporations* as obtained prior to the spin-off.[2]

By the same token, it is implicit in par. 9 of *A.R.B. No. 48* as applied to the spin-off situation, that the spun-off assets should be carried forward in the accounts of the newly-formed transferee corporation at the same carrying amount as they had on the books of the transferor corporation (assuming such carrying amount to be stated in conformity with generally accepted accounting principles). It also appears that such carrying amount should be used in measuring and recording (a) the transferee corporation's issuance of stock to the transferor corporation, and (b) the "cost" to be attributed to such stock on the books of the transferor corporation just prior to the latter's distribution thereof to its stockholders. Of course, if *net* assets were spun off (i.e., assets and liabilities), the stock on the books of the transferor corporation just prior to distribution should be measured by the carrying value of the *net* assets transferred.

2. One accounting problem that might arise as a result of the spin-off transaction in the case of the transferee corporation, is the following: If the *sum* of (a) the par or stated value of the stock issued by the transferee corporation *and* (b) the portion of earned surplus allocated to the latter corporation, exceeds the carrying amount of the spun-off assets, then *either* the stated value of the issued stock *or* the amount of allocated earned surplus to be carried forward, must be reduced to the extent of the excess. If the stated value of the stock *or* the allocated earned surplus, were not thus reduced, the excess in question would have to be reflected as stock discount. (Although with

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[2] Mr. Weldon Powell, in the previously-cited article, states it rather neatly, in part, as follows:

"A fresh accounting start ordinarily occurs when the direct and beneficial ownership of the assets changes — that is, when the assets themselves are sold. . . .

"Otherwise, the element of arm's-length bargaining is deemed a necessary condition for restating assets. Accordingly, in a business separation there probably should be a strong presumption that assets transferred without change in beneficial ownership should be recorded on the same basis in the accounts of the transferee as in the accounts of the transferor." (p. 55)

"Continuance, the very basis for carrying forward earned surplus, ordinarily requires that the stock ownership and control immediately after the separation be substantially the same as immediately before." (p. 56)

Note also the tax regulations, which, in this connection, make reference to "a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization" (see Reg. section 1.368-1(b)).

low par or stated value stocks available, this problem ordinarily should not arise, nevertheless, it is an actual problem that did arise and was brought to our attention.) Where the carrying amount of the spun-off assets exceeds the sum of (a) and (b) above, the difference would then, of course, be reflected as paid-in surplus on the transferee corporation's books.

Another accounting anomaly that can well arise on the books of the transferee corporation under certain circumstances, is a situation in which the amount of earned surplus allocated to the transferee corporation *exceeds* the recorded carrying value of the assets or net assets spun off. If the capital accounts set up for the transferee corporation are to be anchored to (i.e., measured by) the cost of the spun-off assets carried over from the transferor corporation's books, then it is obvious that in the situation described, the entire amount of surplus allocated to the transferee corporation cannot be carried forward. The anomaly described can arise where the transferred assets or net assets are carried forward at cost but the allocation of earned surplus is based on relative "fair values" of assets transferred and assets retained by the transferor corporation. For example, the book value of net assets transferred may be only 50 per cent of the transferring corporation's total net assets, but on a fair value basis, may be twice, five times, or ten times the fair value of net assets retained. The situation would also be affected by another variable, namely, the ratio obtaining in a particular case, between the transferor corporation's stated capital and earned surplus account balances, and the respective amounts of such balances.

3. One of the prime accounting problems arising as a result of the spin-off transaction in the case of the transferor corporation, is the following: First of all, in Kohler's definition of "spinoff" quoted at the outset of this reply, note that the *distribution* of the newly-formed corporation's stock is characterized as a "property dividend." Ordinarily, such a dividend (just like a cash or stock dividend)is charged to earned surplus upon distribution. However, in a number of actual spin-off cases brought to our attention by members, if the transferor corporation charges the distribution of the newly-formed corporation's stock (in the entire amount of its book value) to its earned surplus account, it is then impossible for the transferor corporation to carry forward the full amount of earned surplus allocated to it in the spin-off. Accordingly, we have advised in these cases, where feasible, that the distribution be treated in whole or in part, as the situation requires,

as a *dividend in partial liquidation.*[3] If sufficient paid-in surplus is not available to absorb the requisite charge in whole or in part, it may be necessary to create a reduction surplus for that purpose. It is possible that in certain cases, statutory legal hurdles to creation of sufficient reduction surplus could be encountered, entailing use of the earned surplus account to absorb the distribution. Thus, it may develop that the entire amount of earned surplus (and/or "earnings and profits") allocated to the transferor corporation or a portion thereof, cannot be carried forward.

Institute members have raised questions with us concerning spin-off cases in which the carrying amount of the newly-formed corporation's stock on the books of the old corporation exceeds either the earned surplus or even the total capital and earned surplus of the old, i.e., the distributing corporation. Some of the more bizarre situations along these lines may arise where assets of substantial book value are spun off to the transferee corporation, but the latter *assumes* no portion of substantial correlative liabilities. We have advised that if the "property dividend" is effected under such circumstances, it would seem that a serious legal question arises whether the distribution is an illegal dividend, on the ground that it results in impairment of legal capital. Query then whether, in such circumstances, the transfer of property to the newly-formed corporation may be deemed a "preferential transfer"?

4. A statutory allocation of *"Earnings and Profits"* is required in connection with a divisive reorganization coming within the purview of section 368(a)(1)D of the Internal Revenue Code. Among the allocation bases set forth in the Code are relative fair market values

[3] See section 41 of the *Model Business Corporation Act* (American Law Institute in collaboration with American Bar Association, revised, 1953) which provides for declaration of "Dividends in Partial Liquidation."

In connection with the foregoing treatment of the property dividend, it is interesting to note in passing that "The general (tax) rule . . . that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits does *not* apply to: (1) the distribution in pursuance of a plan of reorganization by . . . a corporation a party to the reorganization, to its shareholders . . . (ii) Of stock . . . in another corporation which is a party to the reorganization without the surrender by the distributees of stock in the distributing corporation. . . ." (See section 39.115(a)–3.)

See section 355 of the 1954 Code which provides for the separation, without recognition of gain or loss to the stockholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation.

Stanley and Kilcullen in *The Federal Income Tax — A Guide to the Law* (Tax Club Press, Tucson, Ariz., 1961) state at pp. 162-3 that section 355 ". . . applies to a distribution of the stock of a controlled corporation regardless of whether the stockholder surrenders stock in the distributing corporation."

or relative net basis of assets transferred and assets retained [see Reg. 1.312-10(a) and (b)(1)].

The method of allocating *earned surplus* of the transferring corporation (as between the spinning-off corporation and the spun-off corporation) may well become legally significant, i.e., in determining the extent of dividends which may be paid by the two corporations.

In addition to the allocation bases mentioned in the Code,[4] consideration should be given to a third method, viz.: If clearly demarcated operating divisions, departments, or plants, or separately discernible operating functions are spun off, then earned surplus may be allocated on the basis of cumulative historical income of the spun-off division or activity and cumulative historical income of divisions or activities not spun off.

In addition to the foregoing allocation bases, Weldon Powell, in his article (*op.cit.supra*) suggests a fourth possible basis, namely, gross earnings. He also suggests a salutary rule to the effect that the initial earned surplus of the transferee corporation should be limited to an amount which "When it is added to the sum of the remaining earned surplus of the transferor corporation . . . , the total will not exceed the amount of the earned surplus (consolidated where appropriate) of the enterprise before the separation."

As a final comment, where the "properly allocable" earned surplus is carried forward in the accounts of both transferor and transferee corporations, the rule of informative disclosure requires that the nature of the reorganization or transactions involved therein be described in a footnote to their statements. This would seem to be especially desirable in the case of the newly-organized corporation since, technically, it is "commencing" its corporate existence with an earned surplus.

[4] For accounting purposes, we can translate the "net basis" method into: ratios of respective book values of net assets (a) transferred and (b) retained, to book value of total net assets of transferor corporation.

Inquiry 460

Carrying value of stock of spun-off corporation in excess of total net assets of spinning-off corporation — feasibility of distribution to complete spin-off

"Accountant is asked to make journal entry for a spin-off.

"Corporation A purchased as sole asset, an office building for X dollars paying in cash 20 per cent of X dollars, balance in mortgage.

"Corporation in first five years earns $15,000 per year after taxes, building up an earned surplus account of $75,000.

"After five years, corporation's earnings after taxes are $25,000 per year, all being paid out as dividends to three individual stockholders.

"After paying dividends for five years, the surplus account reads $75,000, and the corporation refinances its mortgage liability from $300,000 to $800,000. It uses this $500,000 as an investment in the purchase of mortgages, securities and government bonds.

"Corporation A discovers that franchise tax assessment is now based on Article 9a instead of Article 9, and this tax is much higher than it would be if taxed as a real estate corporation.

"Using this as a business reason, it seeks to spin off the $500,000 of investment assets as a tax-free reorganization wherein it will transfer the assets to Corporation B in exchange for the capital stock of Corporation B.

"Corporation A now desires to distribute to its stockholders this same stock but finds that: Issued Capital Stock of Corporation A is $25,000; Surplus is $75,000; and the carrying value of Corporation B stock in the hands of Corporation A is $500,000.

"In spinning off, what journal entry would be made? I would be interested in having your comments."

Our Opinion

In our opinion, the principal questions to be raised in connection with the spin-off transaction which you describe are legal rather than accounting questions.

In the first instance, query whether a franchise-tax-reduction purpose comes within the "business purpose rule" as it has been judicially developed in the cases. As a matter of Institute policy, we are not in a position to answer tax questions. However, we note that Stanley and Kilcullen in *The Federal Income Tax — A Guide to the Law*

(Tax Club Press, N.Y., 1955, with supplement, at pp. 175-6) state that "a scheme that involves an abrupt departure from normal reorganization procedure and that is devised and adopted in connection with a transaction on which the imposition of tax is imminent is not a plan of reorganization within the meaning of the statute." Is "imposition of tax" to be read only as "imposition of *Federal* tax"?

Assuming that you have assured yourself on this and other points and that the spin-off qualifies as a tax-free reorganization, a material question then arises as to whether distribution of the Corporation B stock held by Corporation A to the latter corporation's stockholders constitutes an illegal dividend.

Note that Kohler in *A Dictionary for Accountants* (Prentice-Hall, Inc., N.Y., 1963, at p. 453) defines a "spinoff" as "The transfer by a corporation of a portion of its assets to a newly formed corporation in exchange for the latter's capital stock which is thereupon distributed *as a property dividend* to the stockholders of the first corporation" (*our emphasis*).

In accounting for a property dividend, we assume that in the absence of any more specific directions contained in a board's resolution, the usual presumption would apply, viz., the charge should be made first to any earned surplus, then to any paid-in or other surplus, etc. It is our understanding a liquidating dividend generally must be accomplished in accordance with statutory procedures.

Having in mind the legal rules designed to prevent payment of dividends where such payment will result in impairment of capital [see *Accountants' Handbook* (ed. Paton, Ronald Press, N.Y., 1943, at pp. 1039-40 and pp. 1047-51)], it would appear beyond a doubt that distribution of Corporation B's stock under the circumstances which you outline would result in the impairment of Corporation A's capital. Accordingly, if you have not already done so, we believe you should get some clarification on the legal questions before making *any* journal entry.

Since it is our understanding that New York courts (for better or for worse) have at least in the past adopted the view that increased value of assets constitutes surplus available for dividends [see Randall v. Bailey, (1940) 23 N.Y. Supp. 2d 173, aff'd, (1942) 107 NYLJ 2393, comment, 54 Harv. L. Rev., (Jan., 1941) 505], it would appear that an upward restatement of assets and creation of a revaluation surplus against which to charge the distribution of Corporation B stock, would be about the only accounting alternative. However, as you know, there is a strong "general accounting presumption against departures from cost" [see item, "Auditor's Responsibility When Asset Values Are Written Up," in Carman G. Blough's column in *The Journal of Accountancy* for September, 1953] and accordingly, your own judgment must determine whether there is any sound basis for a property writeup.

In this connection, it should be pointed out that although the recording of Appraisal Surplus on Corporation A's books would expediently resolve the problem of providing an account of a type and amount sufficient to absorb the distribution of Corporation B's stock to Corporation A's stockholders, nevertheless, the appraisal increment would remain on the asset side of the balance sheet, and if allocated to the depreciable portion of the real estate, would require depreciation on appreciation to be charged against future operating revenues. Thus, what started as tax "avoidance" would come back full circle to haunt the corporation if it were to make the spin-off distribution out of a revaluation surplus. The mortgage loan payments in a real sense, through depreciation on appreciation, now become charges saddling future operations.

Incidentally, based on the facts given in your letter, we assume there has been a very material enhancement in the value of the office building. Otherwise, the refinancing of the mortgage from $300,000 to $800,000 is rather inexplicable, unless the officer-stockholders further secured the loan by giving their own personal guaranties and/or pledging their stock.

Inquiry from Same CPA Two Years Later

"A pro forma balance sheet of Corporation A follows. It is desired to 'spin off' certain assets into a new corporation, Corporation B. The assets to be transferred are the mortgages receivable, notes receivable and marketable securities which total $370,000. The mortgage payable is against the real estate only, and the income tax liability is to remain on A's books.

"We would like your opinion as to the accounting entries to be made on the books of Corporations A and B."

CORPORATION A

Balance Sheet as of October 1, 1961

ASSETS		
Cash		$ 25,000.00
Prepaid Items		15,000.00
Mortgages Receivable, Notes Receivable and Marketable Securities		370,000.00
Real Estate	$560,000.00	
Less: Reserve for Depreciation	316,000.00	244,000.00
Land		163,000.00
TOTAL ASSETS		$817,000.00
LIABILITIES AND CAPITAL		
Mortgage Payable		$690,000.00
Income Tax		9,000.00
Common Stock		14,000.00
Surplus		104,000.00
TOTAL LIABILITIES AND CAPITAL		$817,000.00

Our Final Opinion

Although we cannot be entirely sure of the fact, it appears that the same client is involved in the present situation under consideration as was involved in your previous letter to us. Whether or not the same client is involved in both cases, essentially the same facts are involved in both problems. In the earlier case in order to try to complete the spin-off, $500,000 of Corporation B's stock would have to be distributed as a property dividend to Corporation A's stockholders at a time when Corporation A's net worth amounted to only $100,000; in the present case in order to try to complete the spin-off, $370,000 of Corporation B's stock would have to be distributed to the stockholders of Corporation A at a time when Corporation A's net worth amounts to only $118,000. Accordingly, we feel that all the considerations raised in our previous letter to you are still quite relevant and applicable to the present situation.

Inquiry 461

Presentation of three years' income statements for SEC registration, after spin-off of certain operations from corporation seeking to register stock

"We have a problem in prospect in our office upon which we have not been able to fully reconcile our views, and we do not seem to be able to find the answer in SEC's Regulation S-X or other readily available reference material. We would appreciate your giving us your opinion as to the proper treatment.

"We have a parent corporation with twelve subsidiary companies. The active operations of the parent corporation have been:

1. Publication of newspapers.
2. Owners and rental of real estate properties (largely to subsidiary companies).
3. Construction, primarily homes, and other miscellaneous activity which produces commissions, interest, and other types of income.

"The officers of the parent company actively manage all of the subsidiaries, the operations of which are primarily concerned with home development projects and various phases of construction activity.

"For the past year, there have been negotiations for a possible issue of the stock, primarily intending to cover the home building activities. In anticipation of an actual underwriting agreement, public sale, and registration with SEC, the parent company wishes to divorce from the corporation, the newspaper activities and the real estate, representing the rental property activities, into two separate corporations.

"It is anticipated that this would be accomplished as a tax-free spin-off under the provisions of section 355 of the Internal Revenue Code.

"Our question to you has to do with the prospective treatment of the earnings of the past three years of the newspaper and rental departments of the parent company in the registration statement.

"We anticipate that under any circumstances, a full disclosure would be made by footnote of the assets eliminated from the consolidated group through the spin-off. It is probable that this should include an estimate of the earnings of these two departments to the parent company during the past three years, which would not be continued in the succeeding consolidated group.

"Our question is whether or not such a footnote is sufficient. A true past history of earnings would necessarily have to include the earnings of these two departments, which, of course, will not continue on in the consolidated group. Our real question is whether or not the SEC might require something more than the footnote. Would they require that the earnings of these two departments be eliminated from the three years' history of earnings presented in the registration statement and prospectus?

"We have reviewed our Commerce Clearing House service in connection with this point, and about the only thing we find that comes close to an answer to our question is Regulation S-X Rule 5.03(a), which reads: 'The items of profit and loss given consideration in the accounts during the period covered by the profit and loss or income statements shall be included.'

"This rule would seem to indicate that all earnings should be included and that perhaps a footnote explanation would suffice. (The implication of *Accounting Series Release No. 32* seems to be the same.) However, we doubt if the rule was necessarily intended to cover a situation such as we have.

"While at this writing, we have not attempted to effect an allocation of the earnings of these two departments, we would guess that the earnings would not exceed 10 per cent of the consolidated earnings."

Our Opinion

In our opinion, the income statements required to be filed (presumably on Form S-1) for each of the three fiscal years preceding the date of the latest balance sheet filed, may fairly be presented in either one of the following two ways:

1. Using Rule 5.03 of Regulation S-X as a guide, reflect sales, costs, expenses, and miscellaneous other revenues and expenses *relating only to* the home development and other construction projects in that part of the Income Statement covered by items "1A" through "16" inclusive. Line 16 might be designated "Net Income from Home Development and Construction Operations." Then, on line 17, "Special Items," show "Estimated Net Income Applicable to Newspaper Publication and Real Estate Rental Operations." Items 16 and 17 should be keyed to a footnote which would disclose pertinent facts

concerning the spin-off or split-off and which would set forth in some detail the Gross Income and Revenues and Costs and Expenses, as estimated, making up the Net Income shown on line 17, with a succinct statement as to the basis of making the estimate or segregation. Line 18, "Net Income or Loss and Special Items," would represent the historical net income as previously certified.

2. Reflect sales, costs, expenses, and miscellaneous other revenues and expenses *relating to all three* active operations (i.e., newspaper publication, real estate rental, home development and construction) in that part of the Income Statement covered by items "1A" through "16" inclusive. Line 16, "Net Income or Loss," would represent the historical net income as previously certified. On a separate line immediately following line 16, deduct the "Estimated Net Income Applicable to Newspaper Publication and Real Estate Rental Operations," and then, on the final line of the Income Statement proper, as recast or retroactively "pro-formalized," show the balance perhaps described as "Estimated Net Income from Home Development and Construction Operations." The last two lines should be keyed to a footnote similar to the one previously described.

It seems to us either one of the above presentations would fairly present the results of operations in a manner that would be helpful to an investor primarily interested in the earning performance of the residential development and construction activity. We do not know just what the SEC would require in an unusual situation of this kind. One problem that suggests itself has to do with allocation of certain joint costs or expenses. Although the second-suggested presentation would appear to be a departure from the requirements of Rule 5.03 in certain respects, nevertheless, it does have merit, we think, in that the final figure in the Income Statement represents the income of the Home Development and Construction operations as it would have been reflected if the spin-off had been accomplished at the inception of the three-year period for which operations are being reported. If income statements are combined retroactively upon a *pooling of interests* for purposes of comparability, it would seem to follow that in the converse situation, i.e., the case of a spin-off or divisive reorganization, consolidated income may be segregated so as to reflect retroactively, a final figure representing net income attributable to the principal corporate entity remaining, after effecting the spin-off of certain operations to another corporate entity.

INQUIRY: **461**

UPWARD RESTATEMENT OF ASSETS (see "Special Note" at end of this section, on page 1438)

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Some reflections on writeups

The following comments were written in the course of the author's editing of this section of the book.

Assume historical earnings of a company indicate a 15 per cent rather than the industry's average 10 per cent return on net assets employed, i.e., annual "differential earnings" of \$5,000 – \$15,000 average net earnings after taxes on \$100,000 average net assets. We now propose to write up net assets \$50,000 (factor of 10 $\times$ \$5,000 differential earnings). Net assets now become \$150,000. "Differential earnings" ordinarily signifies "Goodwill." However, since the booking of Goodwill in the absence of an actual *bargained purchase* thereof is deemed to be contrary to generally accepted accounting principles, the \$50,000 writeup, although rationalized on the basis of "capitalized earnings," is nevertheless allocated to the depreciable fixed asset accounts. Even *without* depreciation on appreciation, \$15,000 as a percentage of \$150,000 would now indicate a 10 per cent return. *With* \$5,000 depreciation on appreciation taken into consideration, earnings of \$10,000 as a percentage of \$150,000 would now indicate a 6.7 per cent return. First, a number of years' differential earnings are anticipated and reflected as part of net worth. Then, to forestall those anticipated earnings from becoming part of net worth a *second time,* a pro rata portion of such differential profits (reflected as an appraisal increment to depreciable assets) is deducted in a series of future income statements as "depreciation on appreciation." Thus, a "bookkeeping charge" (a cost neither currently nor historically "out-of-pocket") is reflected, with the result that the "true" differential earnings, either dollar-wise or percentage-wise, never appear in any current installment of income.

The appraisal increment to the fixed assets is the "mirror image" of the appraisal surplus initially recorded, and a portion of such "mirror image" (i.e., depreciation on appreciation, a truly hypothetical cost since it represents no actual historical cost outlay) is periodically used to reduce actual dollar earnings; and when such periodic earnings are then related to net assets which have already been increased by unrealized appreciation or anticipated earnings, the rate of return is grossly understated and distorted (i.e., understated dollar earnings as a percentage of overstated net assets). The rate of earnings to sales is also understated.

Even when tax allocation is employed in this connection, there is an understatement of dollar earnings. However, the understatement of dollar earnings is greater when tax allocation is *not* employed, either *initially,* by reducing the entire appraisal increment by the *taxes attributable thereto** (and charging appraisal surplus), or *periodically,* by crediting provision for actual taxes payable (in amount of tax rate $\times$ current charge for depreciation on appreciation) and debiting appraisal surplus.

From a balance-sheet standpoint, if so-called "capitalized earnings" are reflected as part of net assets (net worth) without reducing same for applicable taxes, this would be a case of reflecting an anticipated gain or unrealized capital increment *free* of any tax burden.

If the foregoing observations are sound when based on the initial assumption that the company's operations are *in fact* characterized by differential profits, then consider the accounting distortions and misrepresentations (both B/S and Income Statement) that arise where the company's operations bring only an average or less than average return, and depreciable or amortizable assets are arbitrarily written up! "Capitalized earnings" in this situation might better be described as "capitalized *expediency.*" Other things being equal in such a case – when and as depreciation on appreciation is charged to operations in ordinary course, then what *was* an average return (measured as a per cent of sales or net assets) becomes a less than average return, and what *was* a less than average return may even border on or become a loss (important variables in any given situation, of course, being the relative *amount* of a writeup, the relative *stability* of sales and production volume, the *rate* at which the appraisal increment is amortized, *et al.*).

Incidentally, to the extent that an appraisal increment is attributed to non-depreciable, non-depletable, or non-amortizable assets [land, type (b) intangibles, securities], the "true" dollar earnings (other things being equal) will not be understated as currently reported (no depreciation on appreciation being taken thereon). However, the *rate* of return on net assets will be a rate of return related to a hypothetical, not historical or actual, cost base. The rate of return would be the yield to a "would-be" purchaser of the net assets at the higher book value as reflected, but not a yield based on actual cost to the present ownership or equity interest.

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* That is, taxes *not salvable,* because of *non-tax-deductibility* of appraisal increment in future.

Query: In view of the foregoing — and bearing in mind what are perhaps the two most fundamental principles of accounting, namely, the "cost" and "realization" principles — is the reflection of "capitalized (prospective) earnings" or appraisal surplus as a part of net assets *ever* warranted? If so, under what conditions and circumstances?

Inquiry **463**

Necessity for disclosing cost or basis for determining cost, when major assets written up to appraisal value

"We have been the Certified Public Accountants for a client from the inception of his business ten years ago. This client constructs his own office buildings and operates them. His books have been kept until now on a cash basis for ease in preparing income tax returns.

"At the present time pressure from mortgagees and banks have led him to ask for a certified statement. However, the statement is to be based, not on cost, but on appraised values of all properties, which appraisal is to be made by a nationally recognized firm.

"We will convert the records to an accrual basis (inventories are not a factor).

"The question is: Can we, as independent Certified Public Accountants, give an unqualified certificate where land and buildings, the major assets of the company, are carried at appraisal value, if we disclose all the facts of the appraisal, but do *not* disclose the cost, i.e., where cost is not revealed at all?

"The appraisal will be done by independent nationally recognized appraisers representing national life insurance companies who are the mortgagees. All other records are in perfect order.

"Could we give this certificate with an inclusion of an intermediate paragraph citing the appraisal as a departure from generally accepted accounting principles?

"The client is very insistent that we do not disclose cost; and if we refuse to give him an opinion statement, we will most likely lose the client, who happens to be one of our largest clients."

Our Opinion

You inquire whether you can give an unqualified certificate on a statement which reflects the major assets of the company at appraised value and "where cost is not revealed at all." We cannot determine from your letter whether you mean that the client would omit from the statements, all reference to the carrying basis of the assets, and "bury" the resulting appraisal surplus in capital surplus. Such financial presentation would, of course, be highly irregular and improper; and expression of an unqualified opinion in such circumstances would, in our opinion, lay you open not only to censure for committing an act discreditable to the profession [*Code of Professional Ethics* 2.02(a)], but also to possible criminal charges of being an accessory to the publishing of false financial statements. Assuming study of the appraisers' report and other relevant data indicates that the recorded appraisal amounts are not unreasonable, we believe the rule of informative disclosure would require, as a minimum, that the carrying basis of the assets be indicated, that the person or organization which made the appraisal be identified, and that the resulting appraisal surplus (measuring the difference between cost and appraisal value) be clearly identified and separately shown within the capital section of the balance sheet. Not only should the lenders, based on analysis of the statements in question, be able to gauge the extent of their security for advances made, but also should they be able to relate cost of facilities to the advances made, to determine whether money loaned was substantially spent for the contemplated purpose.[1]

(Two years after the foregoing exchange, we had the correspondence *directly following this* with the same CPA firm.)

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[1] See *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 262, 265, and 500. See also the item entitled "Auditor's Responsibility When Asset Values Are Written Up" which appeared in Carman G. Blough's column at pp. 348-9 of the September, 1953 issue of *The Journal of Accountancy.*

Inquiry 464

Writeup from actual cost recently incurred to appraisal values determined by institutions providing mortgage financing

"Attached is a fotocopy of a letter we received from you some time ago relative to preparing a certified balance sheet based on appraised values, with full disclosure as to costs. This seems permissible under certain conditions. We would like your opinion on the specific conditions hereinafter enumerated.

"A client has developed two large office buildings, each costing several million dollars. This client has for years been a licensed building contractor; he built one of the buildings himself, the other he contracted out at a price which he felt was very close to what it would cost him to build himself. Both buildings have been filled almost to capacity with good tenants, many of them national concerns or large local banks and other financial institutions. All leasing was accomplished by the client and his staff, with no leasing fees or commissions. Staff wages have been charged to expense. The client operates as a proprietorship, and no wages or remuneration of any kind have been charged for his very able and valuable services in building and developing the projects and obtaining tenants and financing.

"Appraisal values are made by the financial institutions (large insurance companies) providing the permanent mortgage financing. Based upon these appraisals, both office buildings have received mortgages at a certain ratio to appraised values. The appraised values for these recently completed (less than one year old) buildings are about $1,220,000 in excess of total book costs. Presumably this excess represents the value of the client's above-mentioned services, the profit that a contractor would ordinarily make on buildings of this size, the earnings value of the many good leases, etc.

"Would it be permissible to prepare a certified balance sheet indicating these buildings at the appraised values totaling $7,220,000, correspondingly increasing the client's net worth by $1,220,000, with a footnote indicating the cost basis to be $6,000,000?"

Our Opinion

In our opinion, there is no authoritative support in the accounting literature for recording the buildings at the appraised values totaling

$7,220,000, under the circumstances described in your letter. Unless there is adherence to cost in situations of this kind, we believe the independent CPA should take an exception in his report.[1]

Inquiry **465**

Corporation wholly-owned by sole proprietor of construction company — transfer of building for amount substantially exceeding actual construction cost

"Following are certain facts relating to audit report presentation. We would appreciate receiving an answer to the question presented after the facts.

"The capital stock of a corporation is entirely held by one individual. This same individual operates a construction firm as a sole proprietor. The corporation signed a mortgage note held by a third party in the amount of $1,200,000. The mortgage is guarantied by the sole stockholder.

"The stockholder drew proceeds from mortgage note as required during construction of a building. After the building was completed by the construction company, the cost was determined to be $1,200,000. The construction company billed the corporation $2,200,000. Entry to record this transaction on the books of the corporation was as follows:

Dr. Building	$2,200,000	
Cr. Mortgage Payable		$1,200,000
Capital Stock		1,000,000

"The billing value of the building is less than its appraised valua-

[1] We believe the foregoing conclusions are borne out by the discussion at pp. 188-9 of Paton's *Asset Accounting* (Macmillan Co., N.Y., 1952); pp. 171-2 of Volume 1 of *Accountant's Encyclopedia* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1962, chapter 6 by J. A. Mauriello); and pp. 236-7, 239, 249-50, 262, and 264-5 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957). For its relevance to the specific question raised, see the correspondence with another Institute member which *directly follows* this.

tion. Cost basis of the building for Federal income tax purposes would be $1,200,000 as provided for by section 351 of Internal Revenue Code.

"What disclosures, if any, are deemed necessary in the first and subsequent audit reports in the opinion letter, as footnotes to the balance sheet, and/or in the descriptive paragraphs relating to fixed assets?"

Our Opinion

In our opinion, it is improper to reflect the building at $2,200,000 under the circumstances described. The transaction between proprietorship and corporation is patently not a "bargained" or arms-length transaction. The two accounting entities involved are commonly-controlled; in substance, cost to the affiliate is cost to the corporation. We believe this conclusion is supported not only by the accounting principle which requires adherence to cost but also by the legal doctrine which requires adherence to the highest standards by directors and officers in any dealings with their corporation.

From what has been stated, we personally feel that the building should be reflected at the same amount as the mortgage payable and that the issued stock should be offset by stock discount (if not donated back as void or voidable upon issuance). This assumes, of course, that $1,000,000 represents the par or stated value of the stock issued.

The money technically was loaned to the corporation as mortgagor and represented advances in the hands of the proprietorship. We find it difficult to regard the "transfer" of the building back to the corporation as involving anything more than a cancellation of the advances from the corporation. If $1,000,000 of cash in excess of cost incurred to construct the building had been paid over to the stockholder-proprietor, because of the absence of an arms-length situation, we personally would also have had difficulty in viewing the payment as something other than a corporate distribution.

We are aware, of course, that our conclusions here are unpalatable and controversial. However, even if one *were* to grant that a replacement or fair value of $2,200,000 can be made out for the building, and that the cost principle may be disregarded, even then, because of the substantially lower tax basis of the depreciable property, we believe it would be proper (assuming a 50 per cent income tax rate and that

$1,000,000 par or stated value of stock was issued) to record the transaction as follows:

Dr. Building	$2,200,000	
Stock Discount	500,000	
Cr. Mortgage Note Payable		$1,200,000
Capital Stock		1,000,000
Deferred Income Tax		500,000

The discussion at the top of p. 500 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) supports setting up the deferred tax (representing loss of future tax-deductibility applicable to the excess of the carrying value of the building over its tax basis). The deferred tax would be amortized against the provisions for taxes actually payable as reflected in future income statements, over the useful life of the property.

Adverting to your specific question, if the original entry made by the client is allowed to stand, in view of what we have stated above, we personally feel that disclosure would not cure the situation, and accordingly, that an adverse opinion would be in order with a statement of the reasons why. [Regarding "adverse opinion," see *Statements on Auditing Procedure No. 32, Qualifications and Disclaimers,* par's 9-12 (AICPA, 1962). Cf. *S.A.P. No. 33* (AICPA, 1963) at pp. 47-8, 59, and 69-70.]

Inquiry **466**

Building constructed by parent for subsidiary and billed at an amount exceeding cost

"We are preparing financial statements for one of our clients as of March 31, 1958. In June of 1957, our client acquired all the stock of another company, there being only one class of stock outstanding.

"During the period August 1, 1957 through March 31, 1958, the parent company constructed a building for the subsidiary company. The cost of constructing the building was approximately $60,000. The president of the parent company insists that the subsidiary company be charged $65,000 for this building, resulting in a $5,000 profit to the parent company.

"I have been requested to certify to the financial statements of the parent company alone, and not to a consolidated statement. I am of the opinion that the $5,000 profit should be eliminated; but in all my research on this point, I can find only cases dealing with consolidations, and in no case can I find anything concrete with respect to such profits on unconsolidated statements of the parent company. I also discussed this matter with several members of the Institute and have gotten different opinions from each member."

Our Opinion

For the only discussion relevant to your problem which we have been able to find, see question and answer 17 at p. 576 of the article, "Some Problems Regarding Consolidated and Parent Company Statements," which appeared in the November, 1953 issue of *The Journal of Accountancy.*

Assuming that the parent company is not regularly in the business of constructing buildings and that the $5,000 "profit" is material in the particular circumstances, as a minimum it seems to us such "profit" should be reflected as a special credit plainly-described, in the income statement of the parent company.

Personally, we agree with your view that the $5,000 "profit" should be eliminated, irrespective of the fact we are dealing here with a separate legal and accounting entity and not with a consolidated entity. It almost goes without saying we do not have a "bargained" or "arm's-length" transaction here — the 100-per-cent-owned subsidiary may be regarded as the "alter ego" of the parent company. However, in the absence of a well-recognized rule requiring that the charge to the subsidiary in excess of cost to the parent be regarded as a return of capital (with consequent credit to the parent's investment account), we are not in a position categorically to recommend elimination of the "profit" in question. Nevertheless, the rule of informative disclosure, we believe, requires a separate showing of the nature of such "profit." By extracting the excess charge from its subsidiary and not applying the excess against its investment, it seems to us the parent "waters" its assets.

From another standpoint, in view of what is stated in par's 1 through 5 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959), we believe you should express an adverse opinion on the parent's statements on the ground that failure to prepare consolidated statements in a proper case results in an unfair presentation.

Inquiry 467

Upward departures from cost — may the CPA "attest" that accounts restated at appraisal value, "present fairly"?

"I am going to set forth the facts of two situations which have recently developed in our office. I would like to know how they should be treated from the standpoint of wording of the opinion paragraph in our certificate.

"In the first circumstance, we were approached by a man who had farmed his own land previously. He was going to continue his farming operations; however, he had accumulated some heavy dirt-moving equipment and wanted to qualify to bid on secondary road-grading work under contracts secured by bid from the State Highway Commission. He had no books of account as such. His principal assets were land and equipment. When we asked for purchase invoices, sales invoices, etc., he had none. A substantial amount of the land had come to him by gift. He did produce deeds to the land, which we examined. We also visited the appropriate county offices to determine that no mortgages or liens, etc., were a matter of record against the land or equipment.

"At our suggestion, the man engaged competent appraisers to determine present fair market values on the land and equipment. After recording these assets at the appraised values, the balance sheet was substantially as follows:

ASSETS:	
Cash in Bank	$ 750
Investments	200
Real Estate at Appraised Value	148,000
Equipment at Appraised Value	31,000
Livestock at Appraised Value	27,000
	$206,950
LIABILITIES:	
Note Payable, Unsecured	$ 8,000
Accounts Payable	175
	$ 8,175
Net Worth of Sole Proprietor	198,775
	$206,950

"The certificate to be signed by the Certified Public Accountant in the Highway Statement reads as follows:

> In our opinion, the accompanying financial statement included in pages ...... to ...... inclusive, sets forth fairly the financial condition of ....as of .... in conformity with generally accepted accounting principles.

"My question to you is whether, under the facts as I have given them, the Accountants' Report may be signed without any exception? I am assuming that if an exception were required, it would be to the effect that the fixed assets are not stated in accordance with generally accepted accounting principles because they were not valued at cost less depreciation based on such cost.

"In this respect, I would call to your attention a paragraph on page 90 of *Special Reports—Application of Statement on Auditing Procedure No.* 28 issued by the American Institute, which is not completely clear to me, and which reads as follows:

> Appraisals. When contractors use appraised values for equipment or other assets, the treatment of appraisals in the accounts, and in the financial statements should conform to generally accepted principles of accounting and generally accepted standards of reporting. . . .

This paragraph is included in a section dealing with Highway Contractors' Prequalification Reports. The point which is not clear is: What *are* the generally accepted accounting principles which govern the treatment of appraisals, other than the matter of disclosure? We are not involved here in a question as to whether disclosure is to be made of the fact that fixed assets are at appraised values. It is agreed that appropriate disclosures will be made. But is disclosure sufficient?

"The second situation I can set forth more simply. It involves a corporation which has recorded land on its books at an appraised value. The appraisal was made approximately five years ago and resulted in writing up the land on the books from $82,500 to $300,000. The appraisal was by competent appraisers. At the latest balance-sheet date, which is the time of our examination, the net worth of the corporation is as follows:

Common Stock	$250,000
Appraisal Surplus	217,500
Deficit	(6,000)
	$461,500

Total assets at the balance-sheet date are $1,315,000. The same basic question arises as in the first situation. In expressing an opinion on the financial condition of the corporation, can the statement be made that the financial position is fairly presented in accordance with generally accepted accounting principles?

"Although perhaps not as important a question, there is another point which I would like to pursue. Would it be necessary to point out that no provision has been made for the income taxes which might have to be paid in the event that the land were disposed of in a taxable transaction? The company has been developing a suburban shopping center and has had a history of losses in earlier years because of accelerated depreciation. However, there have been earnings in the last two years. If this trend continues, and we have every reason to believe that it will, the corporation will continue to be profitable. Therefore, there will be no operating losses available to absorb a taxable gain from the sale of land, if such should ever occur.

"I am aware that the matter of generally accepted accounting principles is under careful review by the Institute and the profession. Nevertheless, until some additional pronouncements are forthcoming, we must live with the present concept of generally accepted accounting principles. I would like an opinion on these questions I have posed.

INQUIRY: 467

But, in addition, I would like to be directed to some written pronouncements of the Institute which cover the situations described herein."

Our Opinion

The Institute's views generally with respect to the use of appraisal values of assets in financial statements are evidenced for the most part in *Accounting Research Bulletin No. 43* (1953) chapters 1, 7A and C, and 9A and B. For a good summary of these views, see the item, "Auditor's Responsibility When Asset Values Are Written Up," which appeared in Carman G. Blough's column at pp. 348-9 of the September, 1953 issue of *The Journal of Accountancy.*

As this article indicates, departures from cost, especially those involving upward restatements of asset values, are rather generally discouraged. However, our personal opinion is that under circumstances such as those in the first situation you have outlined – *essentially one where there are no records of asset costs from which to "depart"* – about the only practical alternative the auditor has if he intends properly to account for all assets, is to recommend an independent appraisal of the fixed assets as a precondition to the issuance of any report on the financial statements. By the very nature of the case, obviously a "fresh start" must be made, and a basis of accountability must be initially established.

Although either method may be suitable, *we are inclined to favor appraisal values built up on the basis of estimates of historical costs of specific assets with appropriate adjustments for accumulated depreciation,* rather than appraisal values arrived at on a "present-value" basis.

Regarding your question, viz.: "What *are* the generally accepted accounting principles which govern the treatment of appraisals. . . . ?" – It goes without saying, not only should there be clear disclosure of the carrying bases of the revalued assets, but also indication of who made the appraisal. Furthermore, subsequent depreciation accounting should definitely be based on values established by the independent appraisal in accordance with provisions of chapter 9B of *Accounting Research Bulletin No. 43.* Also, whether a corporation, partnership, or sole proprietorship is involved, the amount of unrealized appreciation or revaluation surplus should be clearly earmarked in the equity or capital section of the balance sheet. The foregoing then, along with the principles relating to appraisals espoused at pp. 262 and 264-5 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), constitute our view as to the generally accepted principles applying to appraisals. It should be emphasized, of course, that the foregoing principles relate solely to situations in which the recording of the appraisal is a fait accompli.

However, it is clear that the requirements respecting depreciation on appreciation, and disclosure of the carrying basis as well as the unrealized appreciation, *beg the question* whether an upward departure from cost should be made in the first instance. Regarding the second situation described in your letter and your direct question, "can the statement be made that the financial position is fairly presented in accordance with generally accepted accounting principles?" —we would be less than candid if we were solemnly albeit glibly to reply, "Yes, so long as the restatement of the accounts is supported by convincing evidence and effected with due formality." However, this much can be said: that although there is no single AICPA pronouncement that any and all upward departures from cost are contrary to generally accepted accounting principles, nevertheless, the significance of historical cost as the basic "valuation" standard *for purposes of periodic financial reporting* and the strong presumption in favor of adherence to cost, are reiterated and stressed at several places in Institute publications.[1]

Furthermore, in its 1936 *Statement of Accounting Principles Governing Corporate Reports,*[2] the Executive Committee of the American Accounting Association took the position that "Accounting is . . . not essentially a process of valuation, but the allocation of historical costs and revenues to current and succeeding fiscal periods. . . . If values other than unamortized costs are to be quoted, they should be expressed . . . only as collateral notations for informative purposes. . . ." As far as we have been able to determine, this official Executive Committee position of the AAA remains substantially unchanged. Since then, an AAA committee has also taken the position that if a company

[1] See the booklet entitled *The Contribution of the AICPA to the Development of Generally Accepted Accounting Principles for Incorporated Business Enterprises — 1917-1962* (AICPA, 1963). See under heading "Valuation of Assets and Liabilities" at pp. 89-91.

[2] See *The Accounting Review* for June, 1936, at pp. 188-9.

is to prepare statements on a "common-dollar" basis, such statements should be presented not in lieu of conventional statements, but as supplementary material. But it should be made clear in any case that the question and concept of "common-dollar" accounting should be distinguished in kind from piecemeal ad hoc writeups to appraisal values.[3]

Just as a court may properly take "judicial notice" of universally known and accepted facts, so also it seems to us the independent CPA may indulge a strong if not conclusive presumption that the substantial majority of writeups encountered in practice are self-serving and expedient in purpose, and involve at worst, either an outright tampering with the accounts, or at best, an unwarranted optimism and *anticipation of gain.* This statement is not lightly made, being based on scores of cases coming to our attention over the years.

This being the "facts of life," at least from our vantage point, it seems to us that only in rare and very special cases involving upward departures from cost, would the CPA be able to *attest responsibly* that financial position based on the restated accounts "is fairly presented in accordance with generally accepted accounting principles." We personally feel that in any case involving an upward departure from cost, the results of which are reflected in the accounts proper *for regular financial reporting purposes,* the CPA should express an unqualified opinion only if the evidence in favor of the restatement is "beyond a reasonable doubt" – and this, irrespective of the fact that a "competent appraiser" has made the determination of value. Otherwise, the CPA should be prepared to express a qualified or an

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[3] Subsequent to the time when the foregoing was written, *Supplementary Statement No. 1, Accounting for Land, Buildings, and Equipment* was published by the AAA's committee on concepts and standards – long-lived assets (in *The Accounting Review* for July, 1964, at pp. 693-9). This *Statement* concludes that "The *current cost* of obtaining the same or equivalent services should be the basis for valuation of assets subsequent to acquisition, as well as at the date of acquisition. . . ." and that *holding gains and losses* resulting from "(1) specific price changes that reflect altered technology or demand conditions, and (2) movements of the general price level" should be periodically reflected in the accounts. (*our emphasis*) The foregoing *Statement* is the product of a seven-man committee, one member of which dissented. The *Statement* is not deemed to be an official pronouncement of the American Accounting Association or of its Executive Committee.

adverse opinion on the ground of an unwarranted departure from cost.[4]

Although none of the Institute's Accounting Research Bulletins dealing with tax allocation have discussed the specific question whether an appraisal increment should be reduced by the income tax applicable thereto, it would seem that the need for recognizing this point in a particular case should be taken into consideration. In the case of a non-depreciable asset such as land which is written up to a fair market value in excess of cost, the question is moot whether the gross appraisal increment should be reduced by the applicable portion of the capital gains tax which would be payable upon liquidation of such asset. Unless the client were actively engaged in the buying and selling of land, we personally would be less inclined to

[4] For a sobering and thought-provoking critique of the "revaluationists," and restatement of the case for historical cost on the ground that bargained "transactions are the raw material of accounting," see "Why Not Retain Historical Cost?" by Eric L. Kohler (in *The Journal of Accountancy* for October, 1963, at pp. 35-41). Also, for one of the most discerning analyses we have seen in the literature on appraisal writeups, see "Comments on Research Bulletins," by Harry H. Wade (at pp. 217-19 of *The Accounting Review* for April, 1962). For another highly interesting report, see *The Measurement of Property, Plant, and Equipment in Financial Statements* [Summary of Proceedings of Harvard Business School Accounting Round Table, April 29-30, 1963 (pub. by Harvard Graduate School of Business Administration, Boston, 1964; reported by Robert T. Sprouse)]. This round table included twelve distinguished CPA and businessmen participants, a moderator, and two economic consultants. The following summarizes, in part, some personal observations of the moderator and the reporter, after the smoke of battle had cleared away, viz.: "The second accomplishment of the Round Table, we believe, is that it singled out those alternatives that were worth serious consideration. As Appendix B indicates, eight possible solutions were submitted for consideration by the Round Table. Some of these were dismissed in their entirety, and certain aspects of others quite obviously had no support among the participants, and we think it is a reasonable inference that there is little support for them in any segment of the business community. Those rejected are as follows:

"(a) Economic value, or more precisely, the present value of the future earning power of the assets. There was a complete absence of support for such a method of valuation for the foreseeable future. Moreover, there also was strong (although not unanimous) sentiment that it was not worthwhile to bring this possibility into the discussion even as some 'ideal' or 'distant goal' against which other alternatives should be tested. Discussion of this alternative got nowhere.

"(b) Appraisal value. Although some interest was expressed initially in the possibility of basing the measurement on appraisal value, this interest evaporated after the practical problems of implementing a system of appraisals as the normal basis for balance sheet reporting were thoroughly aired. . . . It seemed generally agreed that such a method would not be feasible.

"(c) Market value, without stringent qualification. Although there was some interest in use of market value, those who advocated this had a highly circumscribed notion of market value. There was no support for the idea of using it as the routine basis for balance sheet reporting of most fixed asset items."

reduce the increment for the tax effect, in the case of land. On the other hand, where either marketable securities or depreciable assets have been written up to current fair values, we personally feel that the appraisal increment should be discounted or reduced by the taxes applicable thereto.

Inquiry **468**

Retroactive adjustment for cumulative depreciation on appreciation

"We are faced with an unusual question and would appreciate your comments and recommendations.

"A manufacturing company was incorporated in the state of Texas during the 1930's. This company grew and increased its surplus by earnings.

"In 1948, for various valid business purposes, a Delaware Corporation was formed and by means of a tax-free exchange the Texas Corporation transferred all its assets and liabilities to the new Delaware Corporation.

"Just prior to this exchange the Texas Corporation wrote up the fixed assets of the company to their actual worth. This was done by means of an appraisal of the fixed assets by independent engineers. Their appraisal indicated that the fair value in excess of book value was as follows:

Appraisal Value July 31, 1948		$970,518.12
Cost Value July 31, 1948	$561,713.30	
Less Depreciation	175,567.35	386,145.95
Excess over Book Value		$584,372.17

"The $584,372.17 was set up as 'Appraisal Increase of Fixed Assets' and credited to capital surplus.

"Thus, when the assets of the Texas Corporation were taken over by the new Delaware Corporation and stock issued for the net assets, the fixed assets were set up as follows:

Cost Basis (Net of Depreciation)	$386,145.95
Appraisal Increase	584,372.17
Net Book Value	$970,518.12

and since stock was issued for this appraisal increase, the capital stock account now included this element of appraisal increase.

"For income tax purposes, depreciation has not been taken on the appraisal increase. Nor has a reserve been set up to provide for retirement of some of these assets.

"At this date, more than ten years later, substantially all the appraisal increase remains on the books, with approximately $260,000 for machinery, $220,000 for buildings, $79,000 for land and the balance covering various improvements.

"Since 1948 the company has acquired more fixed assets so that at this time the books show the following:

Cost Basis	$1,366,000
Less Depreciation	810,000
	$ 556,000
Appraisal Increase	580,000
Net Book Value	$1,136,000

"It appears certain that an independent appraisal made at this time would show the value of the fixed assets to be greatly in excess of the net book value of $1,136,000.

"Our thought was to have a new appraisal made with the increase over present book value to be added to the 1948 increase figure and the amount credited to capital surplus. Starting at once, the entire appraisal increase should be amortized based upon useful remaining life of various assets determined during the appraisal. The annual charge for amortization would be an earned surplus charge to the extent of the earned surplus, thereafter the charge would be to capital surplus.

"We favor the appraisal for the following reasons:

1. At this time we have no proper basis for amortizing the 1948 increase and it would appear that in the case of depreciable assets, amortization should follow depreciation.
2. A current appraisal would give us a basis for amortization starting at this time.

3. A current appraisal would give the owners a realistic look at current replacement value that should help their thinking in connection with dividends, realistic net worth, etc."

Our Initial Opinion

Without getting into the question of criteria involved in determining whether a particular upward departure from cost might possibly conform with generally accepted accounting principles, and assuming that the recognition of the appraisal increment in 1948 was supportable on *some* objective basis, we nevertheless do not believe that the 1948 appraisal increase should be further deferred in its entirety whether or not a plan for the future amortization thereof is adopted.

Chapter 9B of *Accounting Research Bulletin No. 43* (AICPA, 1953) deals with "Depreciation on Appreciation." The initial statement on this matter by the Institute's Committee on Accounting Procedure was *Accounting Research Bulletin No. 5* issued in April, 1940. Paragraph 2 of chapter 9B, *A.R.B. No. 43,* reads as follows:

> 2. When appreciation has been entered on the books income should be charged with depreciation* computed on the written-up amounts. A company should not at the same time claim larger property valuations in its statement of assets and provide for the amortization of only smaller amounts in its statement of income. When a company has made representations as to an increased valuation of plant, depreciation accounting and periodic income determination thereafter should be based on such higher amounts.

Based on the foregoing, it seems to us the situation described in your letter requires a major retroactive adjustment whereby earned surplus would be debited, and either the allowance for depreciation or a separate allowance for depreciation on appreciation, credited. The allowance account, of course, should be reflected as a deduction from the fixed assets on the asset side of the balance sheet.

If such adjustment does *not* produce a deficit in the surplus account when made, it would then appear that accumulated earnings have in fact been sufficient to absorb the depreciation on appreciation which should have been charged against income in prior years, and accordingly, that dividend distributions, if any, during the past ten

* The word *depreciation* is here used in its ordinary accounting sense and not as the converse of *appreciation.*

years were made out of earnings, not capital. If on the other hand, the retroactive adjustment results in a deficit in the surplus account, such deficit, it seems to us, measures the extent to which any dividends over the past ten years have in fact been paid out of stated capital and/or the extent to which stated capital has been impaired by operating losses which would have been reflected in prior years if the required procedure of charging depreciation on appreciation had been followed.

It is difficult for us at this distance to say what portion of the $580,000 appraisal increase should be written off as a retroactive adjustment of earned surplus. Of course, $79,000 of the appraisal increment is attributable to land which presumably is non-depreciable both for regular depreciation accounting, as well as depreciation-on-appreciation accounting, purposes. One possible approach would be to determine what portion of the undepreciated cost ($386,146 less cost of land?) of the 1948 complement of machinery, buildings, and improvements has been written off through regular depreciation charges and recognized losses on abandonment since 1948. Thus, if 80 per cent of the undepreciated cost of the 1948 complement of depreciable assets has been absorbed by charges to income, then we believe 80 per cent of the portion of the 1948 appraisal increase applicable to machinery, buildings, and improvements might be currently written off against earned surplus. Another possible approach: If composite depreciation rates based on remaining useful life of machinery, buildings, and improvements determined during the 1948 appraisal, are available, such rates could be applied against the portions of the 1948 appraisal increase attributable to machinery ($260,000), buildings ($220,000), and improvements ($21,000) in determining the cumulative amount of depreciation on appreciation that should have been written off in prior years and which now, in our opinion, must be written off against earned surplus.

One further thought occurs to us: If adjustment is made to earned surplus retroactively to recognize accumulated depreciation on appreciation and a deficit results, then assuming there is no existing capital surplus, you may want to give consideration to the desirability of reducing the par value of the client's capital stock thereby creating a reduction surplus sufficient to absorb the deficit and thereupon writing the deficit off in accordance with quasi-reorganization procedures. This would require a dating of the new earned surplus account from the effective date of the readjustment.

INQUIRY: **468**

Follow-Up Inquiry (one year later)

"You were kind enough to answer my earlier inquiry regarding depreciation of appraisal increase of fixed assets.

"We have advised our client that depreciation should have been provided, but they felt that a large retroactive adjustment at this time would adversely affect their financial statement. When we prepared their fiscal year-end statement during 1960 we took exception, and in our certificate, stated in part:

> In our opinion . . . the financial statements present . . . the results of operations for the year then ended in conformity with generally accepted accounting principles, except as to depreciation on appraisal increase described in Note 1. . . .

NOTE 1 — FIXED ASSETS

> Fixed assets are stated at cost less accumulated depreciation plus appraisal increase. In 1948, the predecessor to the company increased the value of certain fixed assets as per an appraisal by independent engineers in the amount of $584,372.17. At March 31, 1960, there was $533,772.25 of this appraisal increase remaining. No provision has been made for depreciation of these appreciated values. Thus, while the Company has applied generally accepted accounting principles in reference to depreciation based on historical cost, it has not provided for depreciation on the appraisal increase which is also required. However, a current evaluation of certain fixed assets indicates that the fair market value as at March 31, 1960 exceeds the cost basis less accumulated depreciation by more than $533,772.25.

"For the current fiscal year that will close early in 1961, we are urging the client to take some action regarding appraisal increase. A retroactive adjustment would result in reducing the corporation's net worth by approximately $400,000.

"Would the following procedure conform to generally accepted accounting principles? The corporation would change its capitalization through some type of quasi-reorganization. During the course of the reorganization, the remaining balance of the appraisal increase (now at about $530,000) would be charged against earned surplus and capital surplus and the entire appraisal increase would be written off.

"Also, if there was a sound business purpose for a new appraisal increase, a new amount could be set up based on a current appraisal and credited to capital surplus. The new appraisal increase would be charged off against operations in the future based upon the remaining useful life of the various assets appraised."

Our Further Opinion

In the absence of a clear statement in your report *indicating the effect upon net worth and reported net income,* of the client's failure to conform to generally accepted accounting principles (see par. 2 of chapter 9B, *A.R.B. No. 43*), we personally feel that your expression of a qualified opinion on the client's statements for the fiscal year ending in 1960 was unwarranted. It also seems to us a preferable reporting procedure would have been to include all but the last sentence of "Note 1 – Fixed Assets" in a separate paragraph of your report thereby dissociating yourself from the gratuitous information concerning valuation of fixed assets volunteered in the last sentence of "Note 1," etc.

Reading your current letter in conjunction with our previous correspondence, we are reluctant to suggest any approach different from that which we initially suggested.

The fact that the client feels "that a large retroactive adjustment at this time would adversely affect their financial statement" is irrelevant when considered from the standpoint of the CPA's reporting responsibility in a clear case of a client's failure to comply with generally accepted accounting principles.

Paragraph 2 of chapter 9B of *A.R.B. No. 43* unequivocally points out the inconsistency involved in a company's claiming larger property valuations in its statement of assets while providing for the amortization of only smaller amounts in its statement of income. It seems to us the procedure proposed at the end of your current letter may involve a similar inconsistency. It appears that any writeoff of the remaining balance of the 1948 appraisal increase would be premised on the propriety of making a retroactive correction of an accounting error previously made. Therefore, it would seem the company would be estopped from setting up a new appraisal increment immediately after a major scaling down of carrying values. Incidentally, if, justifiably or not, a further appraisal increase *is* set up, the credit should be made to "revaluation surplus" or "surplus arising from appraisal" —not to capital surplus.

You state that a retroactive adjustment (presumably to give effect to cumulative depreciation on appreciation) would reduce the corporation's *net worth* by approximately $400,000. On the basis of the information provided, we cannot tell whether such an adjustment to surplus would result in a deficit, i.e., an impairment of legal or stated capital. We referred to this possible deficit aspect in our previous letter. If such an adjustment would in fact produce a deficit, then this *might* be evidence (depending on past dividend policy) that the demonstrated earnings of the company are insufficient to support a further writeup of assets.[1]

Inquiry **469**

Treatment of revaluation surplus, upon sale of land for amount in excess of its appreciated value

"A client of our firm, a close corporation engaged in rock quarry operations, has requested an opinion audit of the financial statements for their current year. A problem has arisen which I felt may have arisen in your research and work on chapter 9 of *Accounting Research Bulletin No. 43.*

"Our client acquired certain land a number of years ago, which has appreciated considerably in value since date of acquisition. This appreciation has been recorded on the books of the corporation and is presented as 'Surplus from Revaluation.' During the current year, a portion of this land was sold for an amount substantially in excess of the appreciated value of that portion. The question has been raised

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[1] We note in passing a statement made at the bottom of p. 397 in *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), viz.: "It is not expected that quasi-reorganizations will be repeated at frequent intervals, if at all." For additional discussion in *Montgomery* quite relevant to your problem, see under the subheading "Basis of Stating Property, Plant, and Equipment" (at pp. 236-7) and under the subheading "Income Tax on Appreciation of Fixed Assets" (at p. 500).

For other relevant references, see the following items which appeared in Carman G. Blough's column in the indicated issues of *The Journal of Accountancy:*

"Disclaimer Is No Cure for Known Statement Imperfections" (February, 1958, pp. 67-8).

"Expression of a "Do Not Present Fairly' Opinion" (March, 1957, pp. 67-8).

"Auditor's Responsibility When Asset Values Are Written Up" (September, 1953, pp. 348-9).

"Can Denial of Opinion Be Avoided by Clear Explanation?" (November, 1952, p. 606).

"Denial of Opinion Does Not Discharge All Responsibility" (August, 1951, pp. 221-2).

"Footnotes in Annual Reports Disclose Appraisal Values of Fixed Properties" (October, 1951, p. 467).

"Appraisal Values" (January, 1948, pp. 71-2).

"Asset Appreciation" (September, 1948, p. 251).

as to the acceptable accounting procedure concerning a reduction of the surplus from revaluation, on a pro rata basis, for the land sold.

"Carman G. Blough, in *Practical Applications of Accounting Standards,* pages 375-80, touches on the subject of the accounting treatment of revaluation surplus. However, his discussion and also the views presented in AICPA *Bulletin No. 43,* chapter 9, relate to depreciation on such assets. No mention is made as to the effect on revaluation surplus upon disposition of such assets.

"The eighth edition (1957) of *Montgomery's Auditing,* page 395, gives the authors' opinion that appraisal surplus should be viewed as permanent capital, and therefore, not available for subsequent transfer to earned surplus as realized through depreciation or sale.

"Karrenbrock and Simons' third edition of *Intermediate Accounting* also touches on this subject. It is the authors' opinion here that upon the disposal of the assets on which appreciation has been recorded all evidence of the prior appraisal be canceled, and the excess of sales price over original cost would represent an increase in retained earnings.

"We are in agreement with *Bulletin No. 43* relating to the handling of depreciation on appreciation, but we feel that upon the disposal of the appreciated asset, our prior appraisal increase on the asset should be canceled and gain on the disposal of the asset over original cost be recognized in retained earnings which would then be available for the payment of dividends."

Our Opinion

Unless revaluation surplus had been capitalized pursuant to the declaration of a stock dividend thereby formally increasing the legal stated capital of the corporation, we personally see no convincing reason why an appraisal increment actually realized upon disposition of assets should not be deemed part of the dividend base. Even if in the state of incorporation there is a specific statutory restriction proscribing the payment of dividends out of appraisal or revaluation surplus, we presume the operative effect of such restriction is not such that the revaluation surplus is thereby deemed to be part of the corporation's legal stated capital, and what is more important, we presume that the restriction operates *only so long as* the appraisal or revaluation surplus remains *unrealized.*

We note further that in the item "Payment of Stock Dividends Out of Reappraisal Surplus" (in Carman G. Blough's column at pp. 462-4 of the March, 1951 issue of *The Journal of Accountancy*), the following statement is made, viz.: "Many accountants, we believe, would agree that so long as appreciation is unrealized — the values not demonstrated through actual sales of assets — it may be hazardous to use the assumed increase in value as a basis for dividends." In your client's case, it does not appear that the hazard is there.[1]

Inquiry **470**

Transfer of revaluation surplus to earned surplus

"In regard to revaluation surplus, will you please advise me if it is proper to transfer that portion of the annual depreciation that is due to the revaluation surplus, from revaluation surplus to earned surplus. The entire depreciation has been charged to the operations, and after the net profit has been transferred to the earned surplus, can that portion of the revaluation surplus depreciation be reclassified?

"I notice that the minority opinion in chapter 9B of *Accounting Research Bulletin No. 43* dissented to the foregoing procedure but I would like to know what is the present best accounting usage in regard to this question."

Our Opinion

None of the Institute's official bulletins have taken a position on the specific question raised in your letter. As a matter of fact, all discussion of the treatment to be accorded the revaluation credit account (which discussion had formed part of the now superseded *Accounting Research Bulletin No. 5*) was deleted from chapter 9B of *Accounting Research Bulletin No. 43* (AICPA, 1953). Although some pros and cons were set forth in old *A.R.B. No. 5,* there was no indication of a "majority" or "minority" view on the question in that *Bulletin.*

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[1] For additional guidance on the question raised, see the exchange of correspondence *directly following* this. See also pp. 40-2 of *Accounting Research Bulletin No. 5, Depreciation on Appreciation* (April, 1940, now superseded by chapter 9B of *A.R.B. No. 43*). We would call your attention particularly to par. 16 thereof.

Frankly, the question you raise is still very much unresolved – both from the accounting and legal standpoints.

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, pp. 395-6) takes the definite position "that appraisal surplus should be viewed as permanent capital and therefore not available for subsequent transfer to earned surplus as realized through depreciation or sale; . . ."[1]

This question of the ultimate accounting disposition of the appraisal or revaluation surplus, we believe, is inextricably bound up with the legal question whether, in the particular state of incorporation, such surplus is available as a dividend base. For example, if revaluation surplus were to be transferred to earned surplus in a state where use of revaluation surplus as a dividend base is proscribed, it appears the financial statements would have to indicate a restriction on earned surplus to the extent of the revaluation surplus so transferred.

You will note that Seward (see reference, footnote 1) who was chairman of the American Bar Association's Committee on Corporate Laws which formulated the *Model Act,* concludes that under the *Model Act,* "unrealized appreciation in asset values is available as earned surplus" for the payment of dividends. The section of the *Illinois Business Corporation Act* to which he refers (as having been purposely omitted from the *Model Act*) seems to harmonize with the *Montgomery* view mentioned above.

To help clarify some of the basic considerations involved, our personal views on this question are as follows: It seems to us to be a contradiction in terms to hold that "*unrealized* appreciation or appraisal surplus, an *unearned* increment, represents a proper base for either cash or stock dividends, i.e., *when initially recorded, or so long as it remains unrealized.* Some corporate statutes allow both cash and stock dividends therefrom; some allow only stock dividends; others proscribe both cash and stock dividends therefrom. We believe the latter statutes to be most soundly conceived so long as the revaluation surplus remains unrealized.

That many accountants hold revaluation surplus suspect in the first instance is understandable, in view of the nature of the motivating influences and pressures frequently at work in these writeup situations. As often as not, the computation is based on a capitalization of

[1] See also the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) pp. 22.4, 22.7, and 22.33-4, and the article entitled "Earned Surplus – Its Meaning and Use in The Model Business Corporation Act," by G. C. Seward (*Virginia Law Review,* May, 1952, pp. 440-3).

prospective earnings which is more or less belied by the actual historical operating performance. Reflecting a number of years' *expected* earnings (or "super-profits") in the balance sheet, it would seem, runs counter to the rule against anticipation of profit or gain. Furthermore, the gross increment has no future tax-deductibility.

Be this as it may, once the appraisal surplus has been booked, it seems to us the view that such surplus must forevermore be "frozen" as permanent capital is too extreme. We have not encountered in the literature an explicit rationale supporting such view.[2] Just as some accountants may regard the depreciation on appreciation requirement, from a practical standpoint, as a *brake* upon unwarranted upward restatements, it may not be inaccurate to say that some accountants rationalize the "frozen surplus" (i.e., enforced capitalization of appraisal surplus) as some sort of "necessary penalty." Presumably, however, the conventional rationalization of the "frozen surplus" treatment following an upward departure from cost is tied to the concept of the accounting *quasi-reorganization,* i.e., that the writeup is a juncture at which a "fresh start" is being made with a "new basis of accountability," and that the historical cost basis is thenceforth to be blotted out.

From the standpoint that accounting is still generally anchored to historical cost, however, it seems to us that periodic transfer of any *realized* portions of appraisal surplus is acceptable, on the ground that it represents a reversal of what otherwise would stand as a hypothetical charge to earnings, such hypothetical charge being the "depreciation on appreciation" which is *a charge to operations not related to any actual historical cost outlay.* Incidentally, it is interesting to note that the transfer in question is probably the only instance in accounting where a transfer *from equity accounts other than earned surplus* would be made *to earned surplus* (unless one were also to include the writeoff of a deficit against capital surplus in this category).

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[2] In the item, "Accounting Treatment of Revaluation Surplus Account," in *Practical Applications of Accounting Standards* (AICPA, 1957) at pp. 375-7, Carman G. Blough gives support to the "frozen surplus" view; he makes reference to an "upward change in the price level," however, and the necessity for recognizing that "capital must be maintained on the basis of current high costs." Our own remarks here, however, do not have reference to situations in which a *thoroughgoing* price-level accounting might be employed.

Inquiry **471**

Organization of new holding company, with investment stated at twice the underlying net equity of subsidiaries

"It is proposed to form a new company, called P, for illustration. Company P will issue $2 million in stock at par value to the stockholders of several corporations. The par value of Company P stock is to be equivalent to the fair market value of these corporations. The adjusted basis for income tax purposes of these assets on the books of these corporations amounts to approximately $1 million. The fair market value will be determined to a great extent by the stockholders, but will be based to some extent on appraisals by independent appraisers. It is believed that the market value will be realistic.

"We have the following questions:

"1. In the preparation of a consolidated balance sheet and a consolidated statement of operations, will it be necessary to provide for depreciation?

"2. Should the values of the various assets, for convenience, be set up on the books of the individual companies and depreciated upon the basis of the new appraised values?

"3. Can we render an opinion on this consolidated balance sheet and statement of operations, based upon the appraisals of these properties by shareholders?

"4. Assuming that these appreciated values were not set up on the books of the individual companies, must we then compute, or have the employees compute, the depreciation on these properties at the appraised values?"

Our Opinion

Regarding your first and fourth specific questions, if the higher values *were* to be recognized (whether by carrying only the holding company's investment at $2 million *or* by setting the investment up at that amount on the holding company's books and also writing up the underlying assets on the books of the several subsidiaries), it would be improper not to depreciate or amortize the excess of the appreciated values over book values (if allocable to depreciable or amortizable assets). In this connection, see par. 2, chapter 9B and par. 10, chapter 5 of *Accounting Research Bulletin No. 43* (AICPA, 1953). Also, whenever the carrying value of depreciable property on the books is substantially higher than the tax basis of such property, we believe an allowance measuring non-future-tax-deductibility of the increment should be set up against the property and a correlative charge made to revaluation surplus or other capital account.

Regarding your second specific question, we would refer you particularly to a passage in Percival Brundage's chapter on "Consolidated Statements" which is included in *Contemporary Accounting* (AICPA, 1945), viz.:

> Where a parent corporation has purchased the capital stock of a subsidiary at a cost in excess of the capital stock and surplus of the subsidiary, the significant enterprise consolidated investment figure is the cost to the parent company. . . . Cost or book values of assets and reserves provided by the subsidiary under different ownership are not significant unless they happen to coincide with or represent the best evidence of the reasonable value, which at that point is cost to the new owner. After obtaining the dependable information required for the allocation of the consolidated investment, *it is generally preferable to reflect the necessary adjustments in the accounts of the subsidiary* company. In this way, the subsequent financial statements of the subsidiary will meet the accounting requirements of the enterprise without further adjustments in consolidation. (*our emphasis*)

Now, to get down to the case at hand. You will note that the foregoing contemplates an arms-length "purchase" situation. Note especially the author's use of the phrases "subsidiary under different ownership" and "cost to the new owner." The situation set forth in your letter involving the organization of a new corporation to hold the stocks of subsidiaries – one which is characterized, both before and after the fact, by a continuance of the same beneficial ownership – bears no resemblance whatever to an arms-length "purchase" resulting in a new ownership or control of the operating assets. Rather, it should be construed as a "pooling of interests" in which the subsidiaries are being kept alive [see par. 4 of *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957)]. Paragraph 9 of *A.R.B. No. 48* states that "When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations . . . should be carried forward; . . ."

We believe it would be advisable in this case for the new corporation to issue shares having a par value not exceeding the total of the stated capitals of the constituent or subsidiary corporations. The parent's investment should also be recorded at such par value, and when eliminating the investment in the course of preparing consolidated or combined statements, it will then be possible to carry forward the earned surpluses of the subsidiaries into the statements. In this connection, see par's 9 and 11 of *A.R.B. No. 48* and also the item entitled "Long-Range Commitments in Handling New Subsidiaries" which appeared at pp. 71-2 of Carman G. Blough's column in the September, 1957 issue of *The Journal of Accountancy.*

Adverting to your third specific question, since in a pooling of interests, "a new basis of accountability does not arise," we believe you should express an adverse opinion on the consolidated statements if the shareholders' appraisal values are recognized, either in recording the holding company's investment and/or directly introducing such values into the subsidiaries' accounts.

Inquiry 472

Sole proprietorship contractor — writeup of net assets for bidding or prequalification purposes, or upon incorporation

"A sole proprietor contractor has net assets with a cash cost basis of about $100,000. He has never had an opinion report. He now wants an opinion report for bidding purposes. He has said that these net assets are worth about $500,000. About one-fourth of the upward restatement of property will represent equipment and specialized equipment previously charged off as costs on jobs. We have been presented with the following problems:

"1. For bidding purposes, he is insisting that his prequalification report or financial statement show his net assets at a value of about $500,000. He proposes and probably will set these assets up on his books at about $500,000, based upon an appraisal by qualified and independent appraisers. This does not seem to be in accordance with generally accepted accounting principles.

"If this treatment is not in accordance with generally accepted accounting principles:

a. Must we disclaim an opinion?
b. Assuming we may render an opinion, must we take an exception and state that the financial statements are not in accordance with generally accepted accounting principles, and of course, giving reasons?

"2. The client has suggested incorporating and issuing to himself the greater part of the capital stock having a par value of about $500,000. The minority interest to employees will not be substantial. These net assets would be set up on the books at about $500,000, based upon an appraisal by qualified and by independent appraisers. The same questions, as shown under '1,' will apply."

Our Opinion

The following points, in our opinion, should be stressed:

1. There is as yet no official ironclad Institute requirement that the CPA must invariably qualify or express an adverse opinion where there is an upward departure from cost and restatement of asset values in terms of appraisal values.

2. However, an appraisal report is one thing, and a balance sheet prepared in accordance with generally accepted accounting principles yet another. Personally, we believe the CPA has a definite responsibility in the premises to guard against the intrusion of "built-in appraisal values."[1] The most effective way to carry out this responsibility is by expressing an adverse opinion when a client insists, *for purposes of his regular financial reporting,* on departing from the generally accepted basis of accountability, namely, historical cost. In the case you describe, the client appears to "know" what the appraisal value is

[1] What we have reference to here is perhaps the same thing to which the late William W. Werntz was alluding when, in commenting on the proposal in *A Tentative Set of Broad Accounting Principles for Business Enterprises,* by Robert T. Sprouse and Maurice Moonitz (*Accounting Research Study No. 3,* AICPA, 1962) that "All items of plant and equipment . . . be recorded at cost . . . with appropriate modification for the effect of the changing dollar . . . (or) be restated in terms of current replacement costs . . . ," he stated, in passing: "As to fixed assets, we need only consider the variety of 'appraisals' that can be obtained on request." (See pp. 57 and 81 of *A.R.S. No. 3.*)

before the "qualified and independent appraisers" even make their appraisal.

3. In any event, adequate and complete disclosure of carrying-value basis and the name of the person or company making the appraisal, is assumed.

4. Although we are unaware of any written authority supporting such view, we personally would be inclined to earmark unrealized appreciation in the capital sections of the balance sheets of both partnerships and proprietorships. We do not believe the rule of informative disclosure should be any different in this respect than it is for corporations. Conceivably, this unrealized appreciation might be designated as "Capital Arising from Revaluation of Assets," or similar title.

5. Where a client has introduced appraisal values into his accounts, serious consideration should be given to the tax allocation aspect, i.e., "discounting" the appraisal increment for the taxes attributable thereto where the gross appraisal amount substantially exceeds the tax basis. This should be accomplished by setting up an allowance account as an offset to the property accounts.

6. Finally, in our opinion, the same basic considerations should apply in determining the propriety of writeups whether or not a newly-organized corporation is in the picture. One should not be able to do indirectly what one cannot or should not do directly, and there should not be a double standard relating to required accounting disclosures. A client organizing a new corporation and transferring assets thereto for capital stock, should be apprised of the fact that there are such things as stock-watering statutes.

7. To the extent that equipment, prematurely charged off as costs to other jobs, has a continuing useful service value, retroactive adjustment may be made, of course, to correct the over-depreciation and reinstate a portion of original cost. Such adjustment, however, should embrace the deferred tax applicable to the reinstated amount.

INQUIRY: **472**

Inquiry 473

Valuation of hotel property in excess of cost, when organizing new corporation

"I have been contacted by one of the promoters of a proposed corporation for assistance in preparing financial statements to be included in the prospectus. The valuation of the principal asset has presented me with a problem, and I would like to have your opinion before proceeding in the matter.

"The proposed corporation will own and operate a hotel with future plans to own and operate motels also. There are four promoters — an attorney, two salesmen and a hotel operator. The hotel operator now controls a corporation that presently owns and operates a hotel. The existing corporation was organized several months ago and acquired a hotel at a cost of $125,000. It has a mortgage on the property of approximately $100,000 at the present time. The property was appraised at a value of $400,000 at the time of acquisition by an expert appraiser. It is the intent of the promoters to organize a new corporation with an authorized capital of 100,000 shares of common stock with a par value of $5 per share. The promoters will receive 60,000 shares of stock in exchange for the hotel property which the new corporation will acquire subject to the existing mortgage of $100,000. The remaining 40,000 shares of stock will be sold at public offering at $5 per share. The public sale will be restricted to residents of the state of ...., and will not be subject to SEC approval. The promoters want to include a balance sheet in the prospectus which will show a value of $400,000 for the hotel, or a net worth of $300,000.

"Would it be proper for me to allow my name to be used in connection with this proposed balance sheet if full disclosure of the transaction is made in a footnote on the balance sheet?"

Our Opinion

Based on the facts set forth in your letter, in our opinion, not only would it be improper for you to lend your name to the proposed balance sheet under the circumstances but also dangerous or imprudent, bearing in mind the stock-watering statutes and possible State Blue Sky Law requirements.

In the present stage of the development of auditing, we are not aware of any authoritative pronouncement (going beyond a requirement of disclosure) which clearly indicates the CPA's reporting responsibility in situations involving, or possibly involving, watered stock.

However, in our opinion, it is incumbent on the independent accountant to satisfy himself that either directors' or expert appraisers' valuations are not arbitrary or capricious. He should scrutinize such valuations to determine whether they are based on some reasonably objective or conventionally objective valuation criteria. If, on balance, he concludes that directors' valuations are arbitrary and not referable to acceptable valuation or accounting bases, he should qualify or express an adverse opinion and state the reasons why since the most significant phrase in the accountant's opinion is "presents fairly." Once a CPA deems a basis unsupportable, he may not disregard that fact; an unfair representation in a financial statement is not cured merely by disclosure of the basis thereof.

From this distance, the value of $400,000 imputed to the property by the expert appraiser only "several months" after such property was acquired at a cost of $125,000 is not convincing. In the absence of knowledge of facts to the contrary, we presume the rather recent purchase of the hotel was made at arms-length.

The correspondence *directly following* this involves what seems to us to be a rather flagrant case of a writeup of fixed assets by a newly-organized corporation (cost of the assets in question being only 3 per cent of the appraised value). We believe many of the comments made in our reply there (q.v.), are quite relevant to the question you raise here.

Inquiry 474

Issuance of stock based on writeup of fixed assets allegedly purchased at "bargain price" shortly before incorporation

"Our accounting firm has a problem which we present to you for your opinion.

"Three individuals are forming a corporation in a tax-free transaction. The assets to be transferred, in brief, include a nominal amount of cash, rental and utility deposits, and fixed assets. Most of the latter items were purchased at a bargain price a few days prior to the incorporation. The total cost of the bargain purchase of fixed assets to the individuals amounted to $4,500 while since that time they have been appraised at $150,000 by competent independent appraisers. Our clients are issuing capital stock based upon these appraised valuations and are definite in their opinions that the fixed assets be shown at their appraised values in the financial statements without an explanation of the basis of their valuation. Their reason for this presentation is to present a more favorable and more realistic financial picture to their prospective creditors. While they are willing to disclose the details of the bargain purchase and the subsequent appraisals to their banks, they do not desire to make this information available to the various credit reporting agencies. Our problems are:

"1. In a statement 'Prepared Without Audit,' is it our responsibility to disclose the facts regarding the method of valuation of these assets if they are shown on the statements at appraised values?

"2. How does our responsibility differ, if at all, in financial statements on which we express an opinion?

"3. Is a presentation of the fixed assets at their appraised values, under the aforementioned conditions, in accordance with generally accepted accounting principles? If so, we assume that the proper method of computing depreciation as a charge against income is that based upon the appraised values."

Our Opinion

In our opinion, the answer to your first specific question is a resounding "yes." In support of such conclusion, see the item entitled "A Denial of Opinion Does Not Discharge All Responsibility" at p. 99 of Carman G. Blough's book, *Practical Applications of Accounting Standards* (AICPA, 1957). See also the item, "Disclaimer Is No Cure for Known Statement Imperfections," in Mr. Blough's column at pp. 67-8 of the February, 1958 issue of *The Journal of Accountancy*. Note especially the statement therein that "It is not the role of a disclaimer to permit a cover-up of known departures from accepted accounting principles. If flight is desired, no report should be issued at all."[1]

[1] These earlier opinions are now officially supported by *Numbered Opinion 8* of the Institute's Committee on Professional Ethics, entitled "Denial of Opinion Does Not Discharge Responsibility in All Cases" (February, 1959).

Regarding your second question, it seems to us that whether the CPA is expressing an opinion on representations in financial statements which he has examined *or* disclaiming an opinion on statements prepared from the books without audit, his responsibility is the same with respect to the matter of disclosing "a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading." (We express this latter conclusion mindful of the fact that Article 2.02(a) of the Institute's *Code of Professional Ethics* confines itself to situations where an opinion is being expressed on audited statements.)[2]

In the circumstances set forth in your letter, doubtless the rule of informative disclosure requires as a minimum that the carrying basis of the fixed assets be indicated in the balance sheet. In our opinion, the financial statements would be misleading upon failure to make such disclosure. In the absence of a statement to the contrary, there is a general presumption that assets in the balance sheet are reflected at cost. In this connection, note the following from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at pp. 264-5):

> Property Stated on Cost Basis. — It has long been an accepted principle of balance sheet presentation that, unless there is a notation to the contrary, the reader may assume that property, plant, and equipment is carried at cost less allowance for depreciation. Cost means cost in cash or its equivalent. Preferably, the words "at cost" are appended to the principal plant caption to avoid any possibility of misunderstanding.
>
> Property Stated on Bases Other Than Cost.
>
> Appraisal Amounts. — When plant assets are carried at appraised amounts, not cost, the balance sheet should clearly so indicate. It is good practice to indicate in the descriptive matter the fact that the appraisal was made by independent appraisers and the date and basis of the appraisal. The appraiser should be informed of the language proposed to be used and his approval or suggested modifications sought.
>
> If the appraisal was made by the board of directors, by company engineers, or by other employees who may not be considered independent, that fact should be indicated clearly. As stated elsewhere, if study of available data indicates that amounts recorded are not reasonable, the auditor should suitably qualify his report.

[2] *Ibid.*

Your first question under "3" concerns itself with the propriety of the upward departure from cost or the writeup itself rather than with disclosure of the carrying basis once the writeup is made. The Institute's Committee on Accounting Procedure has reiterated the opinion that assets should ordinarily be reflected in financial statements at their unexpired cost to the accounting entity, but the committee has not as yet defined the circumstances, if any, under which upward departures from cost may properly be made. However, we personally believe that if an upward restatement is warranted at all, with the possible exception of *thoroughgoing price-level accounting,* it would be warranted only when the higher values can be clearly and objectively demonstrated, as for example, by reasonably expected earning power based on historical earnings and taking into account additional charges which would arise due to reflection of higher asset values. Appraisals not supported by reasonable expectation of earnings are not generally to be regarded as creditable evidence. What is sometimes called or alleged to be a "bargain purchase" would rarely, if ever, constitute a sufficient basis for an upward restatement. As George O. May once stated it: "As beauty lies in the eyes of the beholder, so value lies in the eyes of the appraiser."

Chapter 9B of *Accounting Research Bulletin No. 43* (AICPA, 1953) deals with "Depreciation on Appreciation" and clearly would require that depreciation be based on the higher appraised values if a writeup is made to reflect such values.

The legal question whether the capital stock is "watered" may arise here. Assuming (based on the origin of your letter) that the client is a California corporation, has it applied to the State Commissioner of Corporations for a permit to issue or sell securities, in accordance with the requirements of the California Blue Sky Laws? If so, was the valuation basis of the fixed assets indicated in the application to the Commissioner (as is required), and did he accept the appraised value (cost of the assets in question is *only 3 per cent* of the appraised value) without question and find the proposed issuance of securities "fair, just and equitable"? If the carrying basis of the assets was indicated to the Commissioner, does the client now propose to circulate financial statements with creditors and others, *not* indicating the carrying basis?

We note also that section 3006-8 of the *California Corporations Code* requires that an annual report be sent to shareholders by the board of directors of every stock corporation, unless the by-laws expressly dispense with such report. In addition to stating that the financial statements shall be certified and prepared in a form sanctioned by sound accounting practice, the statute requires that

> The balance sheet or comments accompanying it shall set forth ... (a) The bases employed in stating the valuation of the assets and any changes in such bases during the preceding year. (b) The amount of the surplus, the sources thereof, and any changes therein during the past year.

Incidentally, *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 500) states that "If recorded in the accounts, an excess of appraisal amount over cost should be reduced, either directly or by means of an allowance, by the estimated reduction in income taxes that would result in future periods if depreciation on such excess were deductible for federal income tax purposes." Query whether the gross amount of a writeup above cost to predecessor, or the writeup net of taxes, should be used in determining the amount of consideration actually paid in on stock issued by a newly-organized corporation?

For that matter, is there any justification here for using values higher than cost to predecessor? Does the fact that one organizes a new corporation and transfers property to it (the beneficial ownership of the property remaining the same) – does this fact somehow magically provide the occasion for accomplishing indirectly without disclosure what one may accomplish directly, if at all, only with full disclosure, namely, a departure from cost? If in a pooling of interests, a "new basis of accountability does not arise," does a new basis of accountability arise when there is a mere change in the form of doing business or in the legal vehicle used for holding and exploiting property?

Inquiry 475

Should recently-purchased assets be written up to appraisal value based on "bargain purchase"?

"We would appreciate your opinion of the position of the independent Certified Public Accountant concerning the following situation:

"1. Corporation A and Corporation B are owned by the same interests.

"2. Corporation A acquires the operating assets and Corporation B acquires the real estate of Corporation C in an arms-length transaction.

"3. An independent appraisal of the real estate by qualified appraisers indicates a substantial appreciation over the amount paid.

"4. It is proposed that Corporation A acquire Corporation B shares by issuing its own shares having a par or stated value equal to the aggregate amount indicated by the appraisal.

"5. For purposes of consolidated financial statements, can this transaction be recognized?

"6. Would it make any difference if Corporation B would revalue its assets based on the appraisal prior to acquisition by Corporation A?"

Our Opinion

As you know, there is a general presumption against upward departures from cost especially to give effect to so-called "bargain purchases." However, there is no ironclad rule against writeups under any and all circumstances. We personally believe that if an upward restatement is warranted at all, with the possible exception of *thoroughgoing price-level accounting*, it would be warranted only when the higher values can be clearly and objectively demonstrated, as for example, by reasonably expected earning power based on historical earnings and taking into account additional charges which would arise due to reflection of higher asset values. Appraisals not supported by reasonable expectation of earnings are not generally to be regarded as creditable evidence. Even this "expectation of earnings" rationale is faulty, for it puts the cart before the horse. In our view, prospective earnings should be reflected in a balance sheet only when they are realized, and therefore, no longer prospective — otherwise, only when they are "purchased" (in the form of goodwill). What is sometimes called or alleged to be a "bargain purchase" would rarely, if ever, constitute a sufficient basis for an upward restatement.

Regarding the situation described in your letter, it seems to us there is a basic inconsistency between the statement that the real estate of Corporation C was acquired in an arms-length transaction and the qualified appraisers' report indicating a substantial appreciation of the value of the real estate over the amount paid. We believe a recent purchase price (which we assume is the case here) resulting from truly arms-length negotiations is ordinarily a more reliable index of current fair value than a so-called independent appraisal. As one prominent independent accountant once put it: "As beauty lies in the eyes of the beholder, so value lies in the eyes of the appraiser."

If the proposed transaction referred to under item "4" of your letter is to be consummated in any event, in our opinion, it should be accomplished in accordance with the accounting principles governing a "pooling of interests," viz., in such manner that a stepped-up carrying value for the fixed assets does not result.

If Corporation A does in fact issue stock to Corporation B stockholders having a par or stated value equal to the aggregate amount indicated by the appraisal, and Corporation B does not actually write its assets up to the appraisal value, then on consolidation, in order to effectively carry out the requirements of accounting for the combination as a pooling of interests, we personally would insist that the portion of the investment representing the writeup be reclassified as *stock discount* in the consolidated balance sheet. When the recent arms-length purchase price is contrasted with the appraisal value, there is fairly convincing evidence that the stock is "watered." If Corporation B makes the writeup on its books and Corporation A records its investment at the appraisal amount, the appraisal surplus would be eliminated on consolidation if the elimination entry was made in the conventional manner. If the independent CPA were faced with this treatment *as an accomplished fact,* in our opinion, the very minimum he should insist on would be disclosure in the consolidated balance sheet that the carrying amount of the fixed assets in question is based on appraisal values (rather than "cost"). If faced with this latter situation, however, we personally would go further and express an adverse opinion on the statements. As we view it, if the subsidiary were to revalue its assets based on the appraisal prior to the acquisition, such upward restatement would conflict with the accounting rule that one does not make a profit on, or does not realize a gain on, a purchase.

Incidentally, if the real estate acquired by Corporation B comprises or includes *depreciable fixed assets,* and if Corporation A persists in recording its investment in Corporation B so as to give effect to the higher appraisal values and/or Corporation B restates its fixed assets to give effect to the appraisal values, then we believe it would be proper to reduce the appraisal value of the depreciable fixed assets by an allowance account, since the appraisal increment attributable thereto does not form part of the depreciation basis for tax purposes.[1]

Inquiry 476

Reflecting TV station's network and channel franchises at appraisal value

"We have the following questions in regard to a television broadcasting station:

"1. Our client states that it is common practice in the television industry to appraise the station's network and channel franchises and reflect such values in the balance sheet with an offsetting credit to an appraisal surplus. The appraisal would be made by an independent person experienced in this work.

"2. Would it be proper to reflect this appraisal in the statements, reflect it as a footnote to the statements, or should it not be shown at all?

"3. How should the actual cost of these franchises be handled if

[1] In this connection, see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at top of p. 500.

the appraisals are not reflected on the statements? Should they be stated at cost, cost less amortization, or at a nominal value?

"We would appreciate your suggestions on the above questions."

Our Opinion

The Accounting Research Bulletins do not expressly proscribe upward departures from cost or the accounting recognition of appraisal values under all circumstances. However, the bulletins reiterate adherence to the cost principle in accounting for assets, and specifically, chapter 5 of *Accounting Research Bulletin No. 43* (1953), at p. 38, dealing with "Intangible Assets," states the following, viz.:

> The initial amount assigned to all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired.

The following statements in *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) should also be given weight:

> ... Intangible assets should be recorded at cost; ... (bottom p.291)
>
> ... When royalty and license agreements have been assigned for a consideration, the cost of obtaining the assignment may be capitalized. (top p. 295)
>
> Only purchased goodwill is recognized in the accounts, and it should be recorded at cost. (bottom p. 295)

See the discussion at pp. 65-6 of the article "The Accounting Picture in the Television Industry," by J. H. Regazzi, which appeared in the May, 1955 issue of *The Journal of Accountancy*. Note the tenor of Mr. Regazzi's comments regarding allocation to the FCC license and network affiliation contracts, of an excess of cost over the book value of the assets of a purchased station. The article does not discuss the propriety of assigning appraisal values to the station's network and channel franchises.

We note also that the *Accounting Manual for Television Stations* (National Assoc. of Broadcasters, 1955) does not specifically provide in its chart of accounts for network and channel franchises. It is also relevant to note that "Schedule 1, General Balance Sheet — Assets" included in "FCC Form 324 – 1952 Annual Financial Report of Networks and Licensees of Broadcast Stations," details the following items:

Line No. 16	Excess of purchase price of broadcast property acquired for use over its net book value in hands of predecessor owner, not charged off	________
17	Goodwill assigned to broadcast service and not charged off	________
18	Acquisition cost of broadcast property not yet distributed to foregoing groups	________

However, the instructions for FCC Form 324 rather clearly tie these items to cost.

In view of what has been stated above, we believe there is little or no authoritative support for the client's reflecting appraisal values for network and channel franchises in so-called all-purpose financial statements. This is not to say such appraisal values may not be reflected in special-purpose financial statements. (See *Montgomery, op.cit.supra,* pp. 96-7.) Also, we believe appraisal values may be disclosed in a footnote to the regular statements provided that reference is also made therein to the person responsible for determining such values. Some companies have been content with a footnote statement to the effect that asset carrying values do not necessarily represent or purport to represent fair market or current replacement values. Personally, unless a special-purpose statement were involved, we would be inclined to avoid all reference to appraisal values either in the statements proper or in footnotes.

At the outset of this letter, we have cited authority to the effect that intangibles should be initially recorded at cost. As for the subsequent accounting for the actual cost of franchises if appraisals are not reflected, as a general guide, see par's 5 through 10 of chapter 5 in *Accounting Research Bulletin No. 43.* But see the criticism of voluntary or discretionary amortization of intangibles in *Montgomery* (*op.cit.supra,* middle of p. 292). The latter reference also states at p. 295 that "Franchises should be amortized over the period of their duration, or charged off when they have demonstrably become worthless."

Inquiry 477

Writeup to appraisal value followed by recapitalization — in which identity of appraisal surplus is lost

"I wish you would advise me as to the proper presentation of the capital account of a corporation where the appraisal surplus has lost its identity in the capital and surplus accounts.

"A local corporation recapitalized and had an out-of-town accountant assist with the work. The capital account at that time stood as follows:

Capital Stock — 40 Shares N.P.V. —	
Contributed value $500 per share	$20,000
Operating Deficit	(7,000)
Net Worth	$13,000

The following journal entries were made to record the appraisal:

Land	$29,442	
Buildings	4,144	
Equipment	221	
Animals, Birds and Fish	40,535	
Organization	13,158	
Surplus		$87,500

To record writeup of fixed assets to their net appraisal value, and to record increase in organization cost.

Capital Stock — Old	$20,000	
Surplus	80,000	
Capital Stock Issued —		
$10 par value — Common		$100,000

After the above entries, the capital account stands as follows:

Capital Stock Issued — 10,000 Shares @ $10	$100,000
Surplus	500
Net Worth	$100,500

"The land and buildings were appraised by local real estate brokers.

The animals, birds and fish were appraised by an employee of the company and relative of the principal stockholder. The actual cost of the animals, birds and fish was less than 10 per cent of the appraised value, and had been charged to expense, the reason being that wild life in captivity has an average of less than a year to live. The appraisal is based entirely upon their value as a tourist attraction. The writeup in organization expense seems to be just an entry to bring the writeup to the desired figure, and neither the officers nor the attorney seem to know exactly what it represents.

"The appraisal of the assets was approved by the Florida Securities Commission. They are, however, holding the original $100,000 of capital stock in escrow which will be released upon presentation of proof to the Commission that the corporation is able to pay dividends of 6 per cent on all outstanding stock.

"As $150,000 of unissued stock is now being sold to the public, it is necessary to present a financial statement which I have been engaged to prepare. Although numerous textbooks show exactly how the reappraised assets should appear on the balance sheet with offsetting entry to appraisal surplus or a reserve for appraisal increment, the exact method of presentation of the capital account in the situation outlined, does not appear in these books.

"As I do not wish to make myself liable in case of failure of the company, I have prepared the capital account as follows:

Capital Stock Authorized, 25,000 Shares @ $10	$250,000	
Less: Unissued	150,000	
Capital Stock Issued	$100,000	
Deduct: Appraisal Surplus allocated to Capital Stock	80,000	
Contributed Value of Capital Stock		$20,000
Surplus from Appraisal		87,500
Operating Deficit		(7,000)
Net Worth		$100,500

"The officers of the corporation believe that such a statement would discourage the sale of unissued stock and desire to show the capital account as reflected by the books.

"I have taken this matter up with several local CPAs, and there seems to be a general disagreement as to the proper presentation, although all agree that some method of revealing exactly what transpired should be used in preparing the financial statement."

Our Opinion

It seems to us that, in a case such as you describe, the rule of informative disclosure requires that the auditor insist on disclosing in the statements themselves and by footnote, the fact that an upward restatement of the client's assets has been made and that a major portion of the consideration for the newly-issued stock has its origin in a capitalization of revaluation surplus. The rules of disclosure applicable in cases of quasi-reorganization seem to be clearly called for in this case. The minimum requirements might be the following:

1. Clear indication in the statement proper of the *basis of the carrying value* for each major category of assets;
2. A new earned surplus account *dated* as of the date when the quasi-reorganization took place;
3. Footnote disclosure of the fact that appraisal values have been recorded and that the revaluation surplus resulting therefrom has been used in part to absorb a previous operating deficit, the remainder being capitalized to furnish the major part of the consideration for newly-issued shares. This footnote should mention the respective amounts involved and should be keyed to the capital stock and dated earned surplus accounts;
4. If the organization expense is *just plain water,* it should be shown as a separate deduction from the newly-issued stock and labeled for what it is: stock discount.

There is, of course, a general accounting presumption against departures from cost. Thus far, the Institute's view with respect to such departures, as evidenced by several Accounting Research Bulletins, is that any danger in regard to writeups is adequately guarded against by firm adherence to the rule that if property is written up, amortization charges against income must thereafter be based on the new and higher values. On the other hand, the abuse of underprovision for amortization is guarded against, to some extent, by explicit declaration of a rule that no charge for writing down property may be made against capital surplus until earned surplus has first been exhausted.

Chapter 7A of *Accounting Research Bulletin No. 43* (AICPA, 1953) relates to quasi-reorganizations which relieve income of charges which otherwise would be made thereagainst, and therefore deals explicitly only with reorganizations resulting in net decreases in the amounts at which the assets are carried. In chapter 9B of *A.R.B. No. 43,* there is a discussion of situations in which the net adjustment of asset carrying values is upward, but the *Bulletin* does not clearly say that such readjustments are permissible. In chapter 9A of *A.R.B. No. 43* upward revisions of asset carrying values to reflect changes in the price level are opposed. There is an implication in the latter chapter, though not clearly stated, that upward readjustments might be accomplished by reorganization, although the circumstances are not discussed. In none of the bulletins thus far issued, is there a clear statement that a general upward revision of the carrying value of assets may ever be regarded as proper; nor is there any explicit statement that such is improper.

Assuming that there *are* some *unique* and *very special* situations in which upward departures from cost may be countenanced, then in our opinion, asset values determined in establishing a new basis for accountability should reflect as nearly as possible valuations meeting arms-length standards. All reasonable safeguards must surround the determination of values established in connection with a restatement, and those charged with the determination of such values or with the approval of resulting representations are obligated to determine and to test them by all significant evidence available. If the auditor has good reason to believe that the writeup has no real basis in fact, or is spurious or whimsical, we believe he should state his disapproval of the upward restatement in his report on the ground that, under the circumstances, such a departure from cost is contrary to generally accepted accounting principles. One thing, it seems to us, should be clear: In passing upon the values directly recorded or to be recorded, in accounts or statements to which he intends to lend his name, the independent accountant should not lightly abandon adherence to the generally accepted principle of historical cost in favor of unilateral determinations of value by appraisers, bankers, brokers, boards of directors, "promoters" or others.

None of the Accounting Research Bulletins has discussed the propriety of, *or apparent contradictions involved in,* creating a revaluation surplus for the purpose of eliminating a deficit. Although the *Financial Handbook* (Montgomery ed., Ronald Press Co., 1937) indicates at p. 587 that a "common method" of absorbing a deficit is by revaluation of assets upward, it is our understanding that, wholly apart from the question of legal permissibility, accounting opinion including the SEC is very much crystallized against such practice.

We should call your attention also to the following miscellaneous matters in connection with your problem:

1. See reference at p. 392 of *Montgomery's Auditing* (Ronald Press, 1949) to the requirement of SEC's *Accounting Series Release No. 15* respecting continuing disclosure (for at least three years) of the amount of any *deficit* eliminated in a quasi-reorganization.

2. We note that section 612.12 of the *Florida Statutes, 1951* makes provision for the issuance of *partly-paid shares.* Also, in perusing the Florida Blue Sky Laws, we note that where there is a registration by qualification, "a detailed statement (must be made) showing the items of cash, property, services, patents, goodwill and any other consideration in payment for which such securities have been . . . issued" and also "the amount of capital stock which is to be set aside and disposed of as promotion stock. . . ." As bearing on your own possible legal liability, we also note that the Blue Sky Law, in addition to other remedies given the purchasers of securities, provides (section 517.23): "The same civil remedies provided by laws of the United States . . . for the purchasers of securities under any such laws, in interstate commerce, shall extend also to purchasers of securities under this chapter."

3. Note that *Montgomery's Auditing* (*op. cit. supra*) in discussing "Organization and Financing Expenses" at p. 390, states that "*Expenditures* and write-offs *incident to* reorganization or *recapitalization* are usually charged against paid-in surplus resulting from the reorganization." (*emphasis ours*)

Inquiry 478

Recapitalization involving elimination of appraisal surplus and capitalization of paid-in surplus

"I would like to present the following problems for your consideration.

"PROBLEM No. 1: An intangible asset (water rights) was established as of March 1, 1913, by an appraisal made in 1920, and the amount so valued credited to a separate appraisal surplus account. Commencing June 1, 1946, the water rights were amortized at the rate of 3 per cent per annum as ordered by the Securities and Exchange Commission. SEC originally ordered that the 3 per cent to be amortized annually be charged against the appraisal surplus account, but later reversed this decision and ordered that the yearly amortization should be charged against income, or after closing, a charge against earned surplus. As a result of the above, my client has been carrying the appraisal surplus account arising from the establishment of an intangible asset, while yearly amortization charges are debited to earned surplus.

"*Question*: *Accounting Research Bulletin No. 43,* chapter 9, section B, entitled 'Depreciation on Appreciation,' states

> When appreciation has been entered on the books, income should be charged with depreciation computed on the written-up amounts. . . . where increased property valuations have been entered on the books the credit item should be treated as permanent capital and would therefore not be available for subsequent transfer to earned surplus as *realized* through depreciation or sale.[1]

In view of the above statements, is there any way, short of complete reorganization, in which this permanent appraisal surplus account can be eliminated?

"PROBLEM No. 2: In addition to appraisal surplus discussed in Problem No. 1 above, a paid-in surplus account has been created from the following transactions:

a. In issuance of additional shares of stock, the amount by which the selling price of the stock exceeded par value was credited to Paid-In Surplus.
b. In a later year, a two for one stock split occurred, whereby two shares of the newly-authorized stock with a par value of $10 a share were issued for each share then held, with a par value of $25 a share. This transaction resulted in the transfer of $5 per share to Paid-In Surplus.

"*Question*: It has been argued both pro and con that paid-in surplus is available for dividends only in the absence of an earned surplus.

[1] With respect to this latter-quoted excerpt, it is important to point out that our correspondent failed to indicate that this view on "non-availability for subsequent transfer to earned surplus" represented the view of only three members of the committee who "assented with qualifications."

Would it be contrary to generally accepted accounting principles if a stock dividend were issued against paid-in surplus, even though earned surplus existed? How would the Securities and Exchange Commission rule on such a transaction?"

Our Opinion

In our opinion, the company's appraisal surplus may be eliminated "short of complete reorganization," and similarly, the paid-in surplus may be eliminated; and such recapitalization may properly be accomplished either (1) by issuing additional shares with a total par or stated value equal to the total amount of appraisal and paid-in surplus transferred to stated, i.e., legal capital, or (2) by increasing to the extent of the total amount of surplus transferred, the par value of shares already outstanding. However, we believe it is extremely important that the recapitalization be accomplished with all due formality. By the latter, we mean that if the corporation accomplishes the recapitalization by issuing additional shares, it should inform its stockholders, by notice at the time of issuance, as to the amount capitalized per share and the aggregate amount thereof, as well as the account or accounts to which such aggregate has been charged and credited. Moreover, every effort should be made to avoid use of both the word "dividend" and "split-up" in related corporate resolutions, notices, and announcements and to describe the transaction as (what we believe it to be, namely,) a "recapitalization."[2] Also, it would seem advisable in a situation of this nature, to get the opinion of counsel whether stockholder consent to the transaction is required, or of such moment in any event, that it be obtained regardless of any express requirement.

Our reasons for the foregoing conclusions are as follows:

1. We do not believe the transaction, especially when accompanied by full disclosure and handled in the manner indicated above, comes within the purview of chapter 7B ("Stock Dividends and Stock Split-

[2] In this connection, see the second complete paragraph, p. 103, of old *Accounting Research Bulletin No. 11*, as well as paragraph 11 at p. 52 of *A.R.B. No. 43* (AICPA, 1953). For a definition of "recapitalization," see Kohler's *A Dictionary for Accountants* (Prentice-Hall, Inc., N.Y., 1952, at p. 355).

Ups") of *Accounting Research Bulletin No. 43*. The shares issued here would not be issued "under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporation earnings . . ." (see *A.R.B. No. 43*, top of p. 49). Furthermore, the "corporation's representations to its shareholders as to the nature of the issuance" are clearly to the effect that a "recapitalization," not a "dividend," is involved; and also a "one-shot" proposition, not a "frequent recurrence of issuances of shares," is here involved (see *A.R.B. No. 43*, par. 16, p. 53).

2. We are not in any position, of course, to give an opinion on the legal aspects of the transaction, and accordingly, legal counsel should be consulted on the question, among others, whether additional shares may legally be issued concurrently with the transfer of both paid-in and appraisal surplus to the category of stated capital. It would appear that the following considerations might be relevant to his determination in this respect. We are assuming that a corporation organized in Wisconsin is involved. Thus, even though section 180.38 of the *Wisconsin Business Corporation Law* (1951) states that "Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation," nevertheless section 180.38(2)(c) thereof states in part that "Dividends may be declared and paid in its own authorized but unissued shares out of any unreserved earned surplus or net capital surplus of the corporation, upon the following conditions. . . . etc." It should be added that although the definitions contained in the *Wisconsin Act* (or in the American Law Institute's *Model Business Corporation Act* which apparently is the basis for the Wisconsin statute), do not expressly refer to "surplus arising from appraisal," close study of the various definitions of terms used in the *Act* seems to imply that "appraisal" or "revaluation surplus" would come within the purview of the term "capital surplus." It does not appear that appraisal surplus or any similar term or concept is referred to anywhere else in the *Wisconsin Act*.

It is also of some interest to note that section 180.16(3) of the *Wisconsin B.C.L.* (1951) reads as follows:

> The stated capital of a corporation may be increased from time to time by resolution of the board of directors directing that all or a part of the *unreserved earned surplus or net capital surplus* of the corporation be transferred to stated capital. The board of directors may direct that the amount of the surplus so trans-

> ferred shall be deemed to be stated capital in respect of any designated class of shares.

Query whether the foregoing language would enable the company to eliminate its appraisal and paid-in surplus without issuing additional shares, either by raising the par value of its stock in corresponding amount or merely designating what is now its capital stock account as "Stated Capital," for statement purposes?

Incidentally, it is of interest to point out that the *Wisconsin Domestic Corporations Law* (*1949*) which presumably was in effect prior to *Wisc. B.C.L.* (*1951*) states [section 182.219(2)] that

> ... any corporation ... *whose property shall have increased in value,* may declare a dividend *either in money or in stock* to the extent of . . . the said increase in the value of its property. (*emphasis ours*)

Inquiry 479

Adverse opinion in case of periodic appraisal of assets of oil company, and failure to base depreciation and depletion on appraisal increase

"We are in the process of making an audit of an oil company. This company has made a practice of appraising the assets of the company each year and recording the appraisal values on the books, and they want their statements to reflect these values. The client has the appraisal of its assets made by an independent appraiser. An officer of the client states most emphatically that a CPA may express an opinion when appraisal values are put on the books.

"They do not calculate depreciation and depletion based on the increase in appraisal value.

"We do not have current information regarding the type of report that we can render in such a situation. We would like to have you express your opinion on the situation."

Our Opinion

In our opinion, the accounts and financial statements should be restored to a cost basis if the independent accountant is to express an opinion on the fairness of the over-all representations.

Of course, the client is free to emphasize in a footnote to the balance sheet that the property accounts are reflected at cost and do not purport to represent current fair values. Also, the client may set forth data on estimated oil reserves, indicating who made the estimates. In special-report situations where a new basis of accountability for assets other than cost has been adopted, it appears that an independent CPA may justifiably express an opinion on the fairness of the statement representations. However, the situation briefly described in your letter involving *periodic* revaluation and *failure to recognize depreciation and depletion, on* appreciation, is patently not such a case.

If the client insists that the accounts and statements be maintained and reflected on the basis described in your letter, then it seems to us if you lend your name to the statements in any way, they should be accompanied by an adverse opinion reading somewhat as follows:

> The Company follows a policy and practice of annually appraising and revaluing its assets rather than adhering to the generally accepted basis of reflecting assets at cost. Appraisal values are periodically determined by an independent appraiser. The periodic adoption of new bases of accountability for assets, with rare exceptions, is contrary to generally accepted accounting principles. As a rule, bases of accountability other than cost may properly be established only in extraordinary circumstances and usually in connection with a reorganization or quasi-reorganization.
>
> The Company does not base its depreciation and depletion charges to operations on the appreciated property values reflected in its books. This runs counter to the generally accepted accounting principle stated by the American Institute of Certified Public Accountants in *Accounting Research Bulletin No. 43,* chapter 9B.
>
> Because of the material deviations from generally accepted accounting principles as described above, we are of the opinion that the financial statements do not present fairly the financial position of X Company at (date) or the results of its operations for the year then ended.

The foregoing adverse opinion may, of course, be preceded by the first (scope) paragraph of the standard short form of accountant's report.[1]

None of the Institute's official bulletins has up to this writing expressly stated that an upward restatement of assets is contrary to generally accepted accounting principles.

With one exception, none of the bulletins has indicated or suggested the particular fact situations (e.g., material change in "replacement value," "discovery value," "bargain purchases," demonstrated "super-earning" power, change of ownership by purchase of stock for an amount materially higher than book value, etc.) in which upward departures from cost should be either countenanced or discountenanced.

The one exception referred to above was in chapter 9A of *Accounting Research Bulletin No. 43* where upward revisions of asset carrying values solely to reflect changes in the price-level (decline in the value of the dollar) were opposed. At that time, the view was emphasized "that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost. . . ." Reference was also made to "the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values." The latter suggests to us that *periodic* appraisals as a basis for regular financial reporting would be deemed completely "off limits."[2]

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[1] We believe *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, pp. 236-7, 249-51, 262, 265, 269-70, 395-6, 420-1, and 500) indicates the current generally accepted views regarding appraisals or departures from cost. In this connection, see also par's 9-12 of *Statements on Auditing Procedure No. 32, Qualifications and Disclaimers* (AICPA, 1962); cf. *S.A.P. No.* 33 (AICPA, 1963) at pp. 48 and 59.

[2] G. S. Hills' *The Law of Accounting and Financial Statements* (Little, Brown & Co., Boston, 1957, at pp. 84-9 and 100) may be of interest in connection with the question raised. For other references of general relevance, see "Upward Restatement of Assets" and "Is This an Occasion for Upward Restatement?" at pp. 371 and 373 of Carman G. Blough's book, *Practical Applications of Accounting Standards* (AICPA, 1957). See also "Reporting on Departures from Accepted Principles" in Mr. Blough's column at p. 56 of the June, 1955 issue of *The Journal of Accountancy*. In the William W. Werntz article, "Dilemma in Today's Reporting," in *The Journal of Accountancy* for November, 1955, the discussion and example given under the heading "Value vs. Cost" at p. 46, should also be of interest.

Inquiry **480**

Writeup to prevent breach of contract clause providing for maintenance of minimum stated net worth

"A client is involved in a controversy centering on a clause in a contract providing for a minimum 'net worth,' and his attorney is requesting any help possible on an interpretation of that term.

"The heart of the problem apparently is whether or not recording appreciation of Fixed Assets based on an appraisal recently completed is permissible as a means of preventing a breach of the contract clause providing for maintenance of a minimum stated net worth.

"Can you suggest sources of information which will yield definitions sufficient to defend a position on the subject in court?"

Our Opinion

We wish to emphasize, at the outset, the fact that there is no single AICPA pronouncement at this writing that any and all departures from cost are contrary to generally accepted accounting principles. However, the accounting literature is replete with discussions which inhibit, or place limitations upon, departures from cost and the recognition of appreciation or fair values in the accounts. The Institute's Committee on Accounting Procedure[1] has reiterated the opinion that assets should ordinarily be reflected in financial statements at their unexpired cost to the accounting entity, but the committee has not yet defined the special circumstances, if any, under which upward departures from cost may properly be made.

Whether or not the specific situation involved in your client's case is one in which the asset carrying values have become so meaningless that a new basis of accountability would be appropriate, is entirely dependent on the facts and circumstances. Thus, if the upward restatement can be justified, let us say, on the ground that *some* accountants might deem it to be acceptable if historical earnings warrant the expectation of future differential profits, then an incidental, albeit important effect, would be the prevention of a breach of the contract clause requiring the maintenance of a minimum stated net worth. Conversely, an arbitrary writeup of assets, the patent purpose

[1] Predecessor of present Accounting Principles Board.

of which is to prevent the breach of this clause in the contract, would not be proper. It seems to us it would be compounding the breach. The objective of such a clause is to assure retention by the company of a significant portion of its *realized* earnings. It seems highly unlikely such a clause should be construed so as to embrace within the net worth formula an unrealized appreciation or appraisal increment based on the extraneous formula and computation of an appraiser.[2]

Inquiry **481**

A. Determining "normal operating cycle" of contractor
B. Reflecting unrecorded appraisal values for selected assets

"A question has arisen in regard to classification and allocation of the current portion of long-term obligations where the operating cycle is a normal two-month period.

"The particular client in mind is a small general contractor who incurs costs during the month, billing as of the 25th, with estimated

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[2] We believe the following references may be helpful in connection with your problem:

1. "Upward Restatement of Assets" in Carman G. Blough's *Practical Applications of Accounting Standards* (AICPA, 1957) at pp. 371-80.
2. "How Realistic Are Modern Accounting Procedures in the Valuation of Business Capital?", by M. Moonitz (in *The Journal of Accountancy* for July, 1953, at pp. 86-9).
3. "What Is Book Value?", by M. H. Stans and J. P. Goedert (in *The Journal of Accountancy* for January, 1955, at pp. 38-46).

4a. "The Valuation of Accounts at Current Cost," by M. J. Gordon, at pp. 373-84.
b. "Revaluations of Fixed Assets," by J. Fred Weston, at pp. 482-90.
c. "Legal Decisions on the Accounting for Corporate Surplus," by S. I. Simon, at pp. 104-08.
(The above articles appeared in the July, 1953, October, 1953, and January, 1956 issues, respectively, of *The Accounting Review*.)

5. *Asset Accounting*, by Paton and Paton (Macmillan Co., N.Y., 1952) at pp. 345 *et seq.* and pp. 371-2.
6. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 237, 250, 269-70, 395-6, 416, 420-1, 427, and top of p. 500.
7. *The Law of Accounting and Financial Statements*, by G. S. Hills (Little, Brown & Co., Boston, 1957) at pp. 87-8 and p. 153 *et seq.*
8. *Handbook of Modern Accounting Theory*, M. Backer, ed. (Prentice-Hall, Inc., N.Y., 1955) at pp. 417-23.
9. "Plant Revaluation" in *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) at pp. 18.1-44.

earnings (completion) through the end of the month. Receivables are realized by the 15th less a retained percentage. This constitutes a two-month operating cycle.

"'*A one-year time period is to be used as a basis for the segregation of current assets* in cases where there are several operating cycles occurring within a year.' (*A.R.B. No. 43,* AICPA, 1953, at p. 21)

"However, judgment must be exercised to determine, based on the nature of the business of the contractor, what the period of his normal operating cycle is. Where the contractor tends to specialize in a certain type of project his normal business cycle is likely to be clearly defined. On the other hand, where his business is diverse and the period for *completion* varies markedly, it would appear that the *longest period representing a substantial portion of the business would represent the normal operating cycle* and all *contracts* with lesser periods would also fall within the working capital classification.

"Is it the operating cycle of the working capital, or the length of the contracts which determines the correct classification?

"Where the normal contract is six months or under, does this affect the operating cycle?

"The particular question has arisen with a bonding company where I have *classified only six months' payments of long-term liabilities as a current liability.*

"Am I correct in my position? In regard to the attached financial statements,[1] a question has also arisen regarding my treatment of showing only six months as the current portion of deferred charges. Is this correct?

"Does the unrecorded appreciation conflict with generally accepted accounting principles? Do you have any comments on the contents of the report?"[1]

Our Opinion

In answer to the question raised in the fifth paragraph of your letter, we believe it is the operating cycle of the working capital rather than the length of the contracts which, when considered in conjunction with the fiscal year, determines the classification of assets and liabilities as between "current" and "non-current." Especially would this be the case where the contract period cannot be equated with

[1] Statements or Report not included here. Substance of what was done may be gathered from our reply.

the period of working capital turnover, as for example, where the contracts provide for partial payments or progress billings related to stages of completion or partial shipments. As stated at the top of p. 21 in *Accounting Research Bulletin No. 43* (AICPA, 1953): "The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an operating cycle."

This having been said, in our opinion, the current classification of only the portion of long-term liabilities payable, and the portion of deferred charges expiring, within six months from balance-sheet date, is contrary to the intent of chapter 3A of *Accounting Research Bulletin No. 43* (i.e., par's 4 through 8 thereof). We believe the rule respecting current classification, espoused in chapter 3A of *A.R.B. No. 43* both for assets and for liabilities, may be summarized as: "the fiscal year or the operating cycle, whichever is *longer*." Accordingly, in our opinion, proper presentation in the situation described in your letter would require that the portions of deferred charges expiring and long-term liabilities payable within one year from the balance-sheet date, be classified as current.

We are inclined to question somewhat the opinion expressed in your report letter to the effect that ". . . the use of appraisal values, for information purposes only, on selected assets does not represent a departure from accepted accounting principles." The manner in which the appraisal values are used, of course, is quite important. For example, in the balance sheet covered by your report, you have included "Unrecorded Appreciation." Apart from the question of the propriety of including an item in the balance sheet proper which has not been recorded in the books (should the statements agree with the books?), we cannot determine from the financial statements in question whether the Statement of Profit and Loss gives effect to depreciation on the appreciation attributed to the building. If it is a fact that depreciation on appreciation has not been recognized, then the spirit of the rule stated in chapter 9B of *A.R.B. No. 43* has not been followed, viz.: "When appreciation has been entered on the books, income should be charged with depreciation computed on the written-up amounts." Analogizing from the legal principle that one should not be able to do indirectly what one may not do directly, it seems to us that the mere fact that representations as to higher values are reflected on the balance sheet but not recorded on the books does not relieve the CPA from insisting on the recognition of depreciation on appreciation.

INQUIRY: **481**

Incidentally, we believe many, if not most accountants, would object to the practice of recognizing appraisal values only for "selected assets" on the ground that if there is to be any departure from costs upward or downward, the necessity of a new basis of accountability for all assets, should be determined.

Another point we should mention: We believe the rule of informative disclosure requires not only that the carrying-value basis be mentioned when it is something other than cost, but also when appraisal values are involved, that there be disclosure as to who made the appraisal.

A final comment regarding the item, "Retained Earnings," which is listed in the balance sheet under Accounts Receivable. In our opinion, the description "Retained Earnings" has become a term of art the connotation of which is restricted to Earned Surplus. Accordingly, it seems that use of the term "Retained Earnings" presumably to refer to and replace the term "Retainages," is unnecessarily ambiguous, if not misleading.

Inquiry 482

Borrowing money to pay dividend which increases existing deficit; writeup of assets despite deficit

"A real estate corporation had an operating deficit at the beginning of a fiscal period amounting to $46,000. During such period, the corporation earned $12,000 and paid cash dividends in the sum of $17,000, the net effect of which was to increase the deficit to $51,000. Money had to be borrowed for the payment of the dividends. Is that good financial prudence?

"Furthermore, in order that the corporation might have a good size surplus to pay dividends, the board of directors at a regular meeting decided to increase the value of the property by $118,000, and this item was credited to an account entitled 'Surplus from Reappraisal of Real Property.' The president of the corporation stated at the meeting that such a procedure would enable the corporation to pay the dividend out of surplus. Is this a proper basis for a cash dividend under the circumstances? Would you construe the procedure as misleading and contrary to honest intentions?

"Your opinion is desired on the action to be taken by the Certified Public Accountant in preparing his report on the above."

Our Opinion

It seems to us that, in a case such as you describe, the rule of informative disclosure would require that the auditor insist on disclosing, either in a footnote to the statements or in his report, the fact that the corporation has paid dividends in an amount exceeding its current year's earnings thereby increasing an already existing deficit (or further impairing the corporation's capital) and has borrowed the money to make such dividend payment.

Similarly, in the case of the upward restatement of asset values and resulting creation of revaluation or appraisal surplus: as a minimum, the auditor should insist on full disclosure in the statements, and that subsequent depreciation should be based on the increased values now reflected in the balance sheet. If the auditor has good reason to believe that the writeup has no real basis in fact, or is spurious or whimsical, we believe he should state his disapproval of the upward restatement in his report (i.e., adverse opinion) on the ground that, under the circumstances, such a departure from cost is contrary to generally accepted accounting principles. The extent to which the net worth and the income statement are affected thereby should also be indicated.

The independent accountant's principal function, of course, is that of making findings of fact based on audit tests and analysis of accounts and transactions, in order to assure himself as to the essential soundness of representations made in financial statements to which he lends his name. Although, as a rule, the accountant may not directly concern himself in his report with whether a client's financial policies are prudent, where certain policies materially affect the financial condition or operations of a client, we think it incumbent on the accountant to disclose such policies.

Rather than attempt to discuss at length your questions regarding the client's borrowing money to pay a dividend despite an already existing deficit, followed by the extraordinary procedure of an upward restatement of asset values and payment of a cash dividend from "surplus" thus created, perhaps we should confine ourselves to the observation that a writeup in the presence of a substantial deficit is prima facie, *a contradiction in terms,* which would seem to put a considerable burden of "explanation" on those responsible for such an aberrant policy.[1]

Inquiry 483

Bank's acceptance of uncertified statements with appraisal values, and rejection of same statements when adjusted to cost and certified

"We ask your opinion concerning a situation which arose recently in our practice involving the presentation of a certified financial statement for bank purposes.

"This client is involved in the retail fuel oil business and has in the past enjoyed a bank line locally in the amount of $200,000 unsecured. When we were engaged, for the first time in the history of the company, a *certified* balance sheet was prepared for presentation to the bank. In past periods, *uncertified* statements included appraisal of fixed assets with a corresponding credit to appraisal surplus, thereby

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[1] For some older-than-usual references which nevertheless are very much to the point on the question raised, see the following:

1. In the *Accountants' Handbook* (Paton, ed., Ronald Press, 1943) the material at pp. 1046-51 should be generally helpful. See especially the paragraphs headed "Dividends and Financial Condition" (p. 1046), "Dividends and Capital Impairment" (p. 1047), and "Surplus from Revaluation as Dividend Base" (p. 1051).
2. In the *Financial Handbook* (Montgomery, ed., Ronald Press, 1937) see the discussion at pp. 583 *et seq.*, especially the material on p. 585, the paragraphs headed "Deficit Must Be Made Up" and "Dividends Prohibited in Insolvency" on p. 587, the paragraph "Dividend Declarations as Influenced by Status of Cash and Working Capital" on p. 590, and "Borrowing to Pay Dividends" on p. 594.
3. In *Montgomery's Auditing* (Ronald, 7th ed.) see the bottom of p. 223, the top of p. 390, and first full paragraph on p. 424.
4. You may also be interested in the following items which appeared in Carman G. Blough's column, "Current Accounting and Auditing Problems," in the May, 1947, March, 1948, and March, 1951 issues of *The Journal of Accountancy*; the items, respectively, were entitled "Paying Dividends During Deficit Period," "Dividend Payments Despite Existence of Operating Deficit," and "Payment of Stock Dividends Out of Reappraisal Surplus."

increasing the net worth of the corporation. Our client requested that, in our presentation of his statement, we do the same, but we indicated that if we were to do so, it would be difficult if not impossible to certify the statements. We acquainted him with all the facts necessary for proper presentation of appraisal surpluses, and a decision was made to present the certified statements in accordance with the method we employed in preparing them, without the appraisals.

"After the bank received the statements, the unsecured line was withdrawn, and the customer was told that it could be reinstated if the statements were submitted with the appraisal figures. I met with the bank official involved, and he informed me that the board of directors look unfavorably upon the financial condition of the company without the appraisal figures. We indicated that we considered it more important for the client to have certified statements which would more satisfactorily present the financial condition of the company, and the bank official agreed during our meeting. However, a week thereafter, he told the customer again that the bank line could not be reinstated without the appraisal figures.

"Our client now insists that we prepare a statement, for bank purposes only, with the reappraisal of fixed assets.

"We ask your opinion as to the desirability of preparing two financial statements, one certified and one uncertified. It should be noted that there are other substantial creditors to whom these statements have been submitted without criticism, since they are primarily interested in securing certified balance sheets and income and surplus statements.

"In establishing our position, we rely upon the American Institute's Committee on Accounting Procedure, *Accounting Research Bulletin No. 5,* which indicates that accounting for fixed assets should normally be based on cost and that appreciation should normally not be reflected on the corporate books of account."

Our Opinion

By way of "understatement," the position taken by the bank under the circumstances outlined in your letter is anomalous. It would seem that a credit grantor properly should be concerned more with eliminating the possibility of watered capital, or with appraising earning capacity or performance, and less with giving rein to the possible puffing of asset values.

If in the past, the bank accepted uncertified statements which included the assets at appraisal values as well as the appraisal surplus, it may be that the bank will still accept uncertified statements. However, if you were to prepare the statements on your own letterhead and use the warning phrase, "Prepared from the Books Without Audit," this would not be proper since you have in fact performed an audit.

One solution here would be to inquire whether the bank would accept financial statements incorporating the appraisal values prepared either on the company's own letterhead or on plain paper, thereby completely dissociating your name from such statements.

If the bank is unwilling to accept the financial statements meeting *their specifications* as to appraisal values prepared either on the company's own letterhead or plain paper, then we believe under the special circumstances, you could prepare the statements reflecting the assets at appraisal values and the appraisal surplus, and then in your report (rather than express an adverse opinion on the statements taken as a whole on the ground that use of the appraisal values is contrary to generally accepted accounting principles) take an exception on the ground that fixed assets should normally be reflected at cost. In taking an exception, you should state the amount of the appraisal increment involved or the cost basis of the assets. We believe you could then give an opinion that the statements "fairly present," *qualified* by reference to your exception. The reason why we feel you may express a qualified opinion in this special-purpose situation and need not disclaim on the over-all representations, is that the amount of the distortion or upward departure from cost can be measured and disclosed with relative simplicity.

We assume in all of this that any profit and loss statement accompanying the balance sheet would reflect depreciation on appreciation. We assume further that the carrying basis of the assets will be clearly indicated in the balance sheet proper.

One further important point: So that the bank will be estopped from yelling "fire" at a later date and from making charges that the client has made false representations in the statements, we believe both the client as well as your firm should make exculpatory evidence now by reducing your previous conversations with the bank official concerned to formal minutes to be filed for possible future reference.

Inquiry **484**

Reporting on statements of hospital; where substantial assets of plant fund reflected at appraised value, and depreciation rates applied to sound value

"Our firm prepares an annual report for a non-profit general hospital in Illinois. In the past we have denied an opinion for three reasons:

1. We did not confirm the Patients' Accounts Receivable.
2. There was not sufficient control over Inventories.
3. The Plant Fund, in addition to the cost of certain fixed assets, also contained fixed assets at appraised values, and depreciation had been computed on the appraised values.

"The financial statements are given to governmental agencies and to two third-party organizations, each year.

"The Administrator requested, if it were at all possible, that we render an opinion, in a short-form report, for the year ended December 31, 1962. To this end, we are to confirm Patients' Accounts Receivable on a test basis; perpetual inventory records have been installed, and we are to test the physical quantities and pricing of the inventories at December 31, 1962.

"But there still remains one basic question in our minds, and that is: Can we render an unqualified or qualified opinion on the financial statements, when a substantial amount of the fixed assets of the Plant Fund are stated at appraised values, and with depreciation being provided on those appraised values?

"Here are the facts: The hospital began operations in 1905. Prior to September 30, 1954, no adequate records had been kept for the cost of land, buildings, or equipment, and depreciation was never taken on the depreciable assets, so far as we could ascertain. Apparently, the hospital had charged off all fixed assets, as the books were maintained on a cash basis when we took over the work as Certified Public Accountants.

"The hospital retained the services of a national firm of appraisers, who made an appraisal of all hospital fixed assets including the land, buildings and equipment, and rendered a valuation report as of September 30, 1954.

"In their report, the appraisers stated that:

> All items are first priced at the present day cost of new replacement at the nearest or best market. We have then shown the depreciated or sound values. These values are derived from the replacement cost by deducting the accrued depreciation. In estimating depreciation, consideration has been given to the condition of each item or related group, as revealed by our personal inspection, also to the age of the asset and its relative current utility. Values determined are as of a going concern, and are not liquidating or disposal values.

"The hospital recorded the fixed assets on its books at replacement cost with the difference between replacement cost and sound value being credited to the allowance for depreciation at September 30, 1954.

"Since that date, depreciation has been computed on the sound appraised value and *not* on replacement cost, at rates suggested by the American Hospital Association. The depreciation expense, so computed, has been included in the Statement of Income and Expense of the hospital from October 1, 1954, to the present.

"From all evidence presented to us, we are of the opinion that the appraisal amounts were conservative, and we know that the rates of depreciation in use are in line with those recommended by the American Hospital Association.

"We include in our report, each year, a schedule of fixed assets and allowances for depreciation of the Plant Fund, segregating therein the fixed assets at appraised value and the fixed assets at cost (acquired since September 30, 1954), as well as the allowance for depreciation on each. An analysis of the General Fund Capital and the Plant Fund Capital is also included as a part of the financial statements.

"This hospital had no alternative but to set up appraised values on the land, buildings and equipment, as no adequate records of the cost of assets had been maintained prior to September 30, 1954.

"These are the facts of our problem and we would appreciate an opinion, as to:

"1. Are the facts adequately disclosed in a short-form report, in this instance?

"2. Can we give an unqualified opinion on the financial statements based upon those facts?

"3. If a qualified opinion is required, could you suggest the wording of such an opinion to be included in a short-form report?"

Our Opinion

Based on the description contained in your letter, it seems to us you may properly express an unqualified opinion on the hospital's financial statements *if* the depreciation rates applied to the appraised sound value of the hospital plant and equipment are based on the *remaining useful lives* of such plant and equipment as determined at September 30, 1954. In all likelihood, the rates suggested by the American Hospital Association would relate to the useful lives of the several types of plant and equipment *when new,* and ordinarily should be applied to the gross cost or replacement value to determine a proper depreciation provision. Another complicating factor here is the appraisers' estimate of accumulated depreciation applicable to the appraised property, viz., the question as to what rates are indicated as having been used by the appraisal company. It would be anomalous, to say the least, to reflect the appraised assets in the statements net of depreciation allowance accounts which have been accumulated in part at rates determined by the appraisal company and in part by applying *different* rates intended by the American Hospital Association to apply to the gross cost of new facilities, to sound value or net depreciated cost of such appraised assets.

Incidentally, since a depreciation rate based on *useful* life of equipment would be lower than a rate based on *remaining useful* life of equipment, it may be that the client has been applying the lower rate to the low base (i.e., the sound value) rather than the higher rate to the low base. If the lower amount of depreciation thus computed has been used in supporting claims for third-party payments (especially if the third-party organizations accepted the appraisal values as determined in 1954 as a basis for depreciation computations), then the client may have grounds for revising its previous billings to third-party organizations to seek reimbursement for the excess of the proper amounts of depreciation over the miscalculated amounts previously rendered.

To sum up, provided you are satisfied in all other audit respects (e.g., inventory, receivables, *et al.*), we believe you may properly express an unqualified opinion on the statements either under the condition specified in the first sentence of this reply, or if that condition does not obtain, then on condition that the accumulated depreciation allowance accounts are adjusted to reflect the proper amount of depreciation which should have been added to such allowance accounts since September 30, 1954, as determined either by applying the higher rates (related to *remaining useful lives*) to the low bases (sound values) or by applying the lower rates (related to *ordinary useful* lives) to the high bases (gross replacement costs). In this connection, the provision for depreciation in the hospital's current Statement of Income and Expense would also have to be revised.

If such adjustments are indicated as necessary but not made, you may express a qualified opinion if you can compute and state (in a separate second paragraph of your report), what the accumulated depreciation allowance(s) should be if rates were applied to the proper depreciation bases, and what the proper amount of the current depreciation provision should be together with its effect on the amount of income (or loss) otherwise reflected.

If you are not in a position to do any of the foregoing, then we believe you would have to express an adverse opinion[1] on the over-all representations in the statements on the ground that the computations of the current depreciation provision and accumulated depreciation allowance(s) are erroneous.

We are not in a position to suggest appropriate language for your report, since we do not know just what situation you will be facing.

Incidentally, we have no particular quarrel with use of the appraisal values in the statements in this case, for the principal reasons that, prior to September 30, 1954, the hospital had not maintained adequate records as to the cost of its plant, and with the growing importance of third-party payments in the hospital field, now must necessarily have *some* basis for supporting its charges. We also note (in the schedule included with your letter) the fact that the assets at appraised value net of depreciation as computed, represent only about 52 per cent of total depreciable assets. This schedule of fixed assets and allowances for depreciation of the Plant Fund, also indicates quite adequately the carrying bases of the respective groups of assets, i.e., those carried at appraised value and those carried at cost when acquired.

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[1] See *Statements on Auditing Procedure No. 32, Qualifications and Disclaimers* (AICPA, 1962), esp. par's 9 through 12. Cf. *S.A.P. No.* 33 (AICPA, 1963) at pp. 48, 59, and 70.

Inquiry 485

Equity method of reflecting finance company's investment in unconsolidated insurance subsidiary

"This letter is written in an effort to provide an answer to a problem presented by one of our clients. Our client is in the personal finance business and its organization is made up of a parent company, approximately eighty finance business subsidiaries, and one general insurance subsidiary, all of which subsidiaries are wholly-owned. The problem is as follows:

"In prior financial statements, the insurance subsidiary has been consolidated together with the finance subsidiaries. The company now wishes to treat the insurance company as a non-consolidated subsidiary and to present on the consolidated balance sheet the asset 'investment in non-consolidated insurance subsidiary — stated at the amount of equity in capital stock and retained earnings.'

"There appears to be sufficient precedent for treating the non-consolidated subsidiary in this manner on the consolidated balance sheet. However, there is a problem as to 'generally accepted accounting principles' with respect to insurance companies, since the state insurance regulations throughout the country require that marketable securities be stated at market value rather than cost on the insurance company's balance sheet. We want your opinion as to whether the company would be justified in including the excess of market value over cost in the income of the insurance subsidiary which is transferred to the consolidated income statement, and also including this increment in the investment asset on the consolidated balance sheet. If this were to be permitted, do you feel that an income tax provision on this unrealized income would be mandatory?

"At present there is an appraisal surplus related to real estate on the insurance subsidiary's balance sheet. Would you give us your opinion as to the propriety of including this amount in the investment asset on the consolidated balance sheet with a corresponding appraisal surplus. The insurance subsidiary proposes to charge operations with depreciation on the appraisal increase as well as cost.

"The client feels that the insurance business is sufficiently different from the finance business to justify the non-consolidation of the insurance company. Furthermore, this subsidiary cannot be consolidated in Security and Exchange Commission filings. The indentures provide that the income of all subsidiaries (including the insurance company) is to be considered in determining surplus available for dividends.

"In giving us your opinion on these matters, please assume that the amounts involved are material. We would like to know not only the preferred treatment but also what you might consider to be permissible treatment."

Our Opinion

Accounting Research Bulletin No. 51, Consolidated Financial Statements (AICPA, 1959, par. 19, pp. 46-7) states in part:

> There are two methods of dealing with unconsolidated subsidiaries in consolidated statements. . . . The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company . . . in the subsidiaries' net income or net loss, . . . (Adjustments of the investment would also be made for "special" debits or credits shown on the income statements of the unconsolidated subsidiaries below the net income for the period, and for similar items shown in the schedule of earned surplus.)

It appears that the foregoing "preferable method" would result in reflecting the controlling company's investment *at net equity* only if the controlling company's investment cost and its underlying net equity at date of acquisition were equivalent *and* if the subsidiary had *not* recorded unrealized appreciation or unearned increments in its accounts subsequent to date of acquisition.

We find that many of the texts, in referring generally to the method of carrying an investment "at cost *as subsequently adjusted*" are not as precise in their language as perhaps they should be. For example, the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) at the top of p. 23.11 describes one of the common methods of recording an investment in a subsidiary as follows: "Record the investment at cost when acquired but take up the parent company's share of *fluctuations in* the subsidiary's net worth as shown by subsidiary books." Again, at the bottom of p. 23.12 of the *Handbook,* appears the subheading, "Investment Account Adjusted to *Changes in* Book Value." Another example of what we have in mind is the following statement at the bottom of p. 290 in *Montgomery's Auditing* (Ronald Press Co., 1957), viz.: "Investments in subsidiaries may be carried at amounts adjusted periodically *to reflect underlying net assets* of the subsidiaries, . . ." (*our emphasis*). If one reads on, however, it usually becomes clear that the authors are thinking primarily in terms of adjusting the investment *for realized profits and losses* of a subsidiary – in other words, not for *all* fluctuations or changes in underlying net equity. Based on a careful reading of the excerpt quoted in the initial paragraph of this letter from *A.R.B. No. 51*, it is not unreasonable to conclude that the Committee on Accounting Procedure is recommending adjustment of the investment for *realized* profits and losses of the unconsolidated subsidiary, including material-extraordinary charges and credits to surplus recognized during a period.

To advert to the specific questions raised in paragraphs 3 and 4 of your letter, and based on the foregoing, in our opinion, it would be improper for the company to include "the excess of market value over cost in the income of the insurance subsidiary which is transferred to the consolidated income statement." Investment trusts which conventionally carry their portfolios of securities at market carefully distinguish between realized income and profits and losses on sales of securities *and* unrealized appreciation on securities. In the case of these companies, the unrealized appreciation is included in the balance sheet but excluded from the income statement. We do not believe any different principle or practice in this respect should apply to an insurance company. Our personal conclusion on this matter is that it is preferable to adjust the investment for realized profits and losses only; but probably acceptable to adjust the investment for unrealized increments or decrements recorded in the subsidiary's accounts as well as for realized profits and losses. However, if the latter procedure of adjusting the investment is followed, we believe the portion of any adjustment representing appreciation not realized by the subsidiary should be *excluded* from the consolidated income statement. Only the portion of the adjustment representing profits and losses realized by the subsidiary should be taken up through the consolidated income account. In our opinion, the portion of any adjustment representing unearned increment (whether due to a recorded increase in market value of the subsidiary's securities or an upward restatement of the subsidiary's fixed assets to appraised values) may appropriately be reflected in the net worth section of the consolidated balance sheet under a heading such as "Unrealized Appreciation of Unconsolidated Subsidiary's Investments in Securities and Fixed Assets."

Furthermore, we believe that any increase in market value of securities or appraisal increment for depreciable fixed assets recognized in the subsidiary's accounts, should be recorded net of estimated applicable income taxes. For sound support of this latter conclusion, see pp. 500 and 139-41 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957).

For an interesting example of a finance company's treatment of its investment in unconsolidated insurance company subsidiaries, see the financial statements and notes thereto in recent annual reports of C.I.T. Financial Corporation and Subsidiaries.

Inquiry **486**

Use of appraisal values where no cost figures available

"I am conducting an audit of a Boy Scout Council. The assets of the Council will include three Boy Scout camps which generally have no cost figures available. The camps were recently appraised, and it is expected that the appraisal value will be used in the balance sheet. If an opinion certificate is required, can I give such a certificate using such appraisal values if I think they are reasonable?"

Our Opinion

"Departures" from cost, especially those involving upward restatements of asset values, are rather generally frowned upon. However, it seems to us that in a situation such as you have outlined – essentially one where there are no records of asset costs from which to "depart" – about the only practical alternative the auditor has if he intends to reflect full accountability for all assets is to recommend an independent appraisal of the fixed assets as a precondition to the issuance of an unqualified report on the financial statements.

We believe it is considered good practice to include in your report the date of appraisal, the basis of the appraisal, and the fact that the appraisal was made by independent appraisers *or* by officials of the Boy Scout Council, or other employees who may not be considered independent. There should, of course, be clear disclosure of the carrying basis of the revalued assets, and if depreciation accounting is employed, it should definitely be based on values established by the appraisal [see chapter 9B of *Accounting Research Bulletin No. 43* (AICPA, 1953)].

It goes without saying, if you are to lend your name to the statements, you should review the appraisal report and procedures, and be reasonably satisfied therewith.

Inquiry 487

Accounting entry when donating appreciated property

"We have an accounting question which we would appreciate your answering regarding the journal entry to make when donating appreciated property. One example is a corporation dealing in land that has recorded on its books a parcel of land at a cost of $2,000. The land has a fair market value of $10,000 and is donated to a school. A second example is a corporate retail store that has a bicycle that cost $25 and said cost was charged to purchases. The bicycle has a retail price of $35 and is donated to a school."

Our Opinion

None of the Institute's Accounting Research Bulletins have ever discussed the manner of recording on the donor's books the donation of property which has appreciated in value. We know of no accounting principle that would require any recognition by a donor of the increment in value of a parcel of donated real estate, or of an item of donated merchandise inventory. We would be inclined to account for the transaction strictly in terms of its cost, and not to account for the increment on an "as if" basis, i.e., as if the property had been sold at a profit free of tax, and the gross proceeds then transferred to the donee. Accordingly, we believe upon donation of appreciated property, the item should be removed from the asset account at its cost or carrying value with a corresponding debit in identical amount to a donation or contribution expense account. However, where amounts involved are material, we believe it would be desirable to disclose in a footnote to the financial statements that property with an acquisition cost of $XXX had a market value of $YY at the time of its donation to a charitable foundation during the fiscal year.

As an alternative to footnote disclosure of the tax effect of this transaction, we believe the following financial presentation would be informative:

Net (Book) Income before Taxes
Provision for Income Tax Applicable Thereto
Net (Book) Income after Taxes
Special Credit* – Tax Reduction Resulting from Tax Deduction of Excess of Fair Value over Book Value of Donated Property
Net Income Transferred to Retained Earnings

* The correlative debit to the special credit would be a charge to the estimated liability for Federal income taxes.

A question similar to the one you raise often arises when dividends are paid in property other than cash. See the discussion of this question at pp. 404-05 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957).

Inquiry **488**

SEC policy when assets reflected at appraisal value

"We are writing in regard to a particular problem involving a filing with the Securities and Exchange Commission.

"One of our clients proposes to transfer real estate and machine tools to an already existing manufacturing corporation in exchange for stock. Stock is proposed to be issued in an amount equal in value to the present appraisals of the real estate and machine tools. The real estate and machine tools are readily marketable.

"The increase in value by appraisal above the historical cost, less depreciation, is quite substantial. For the purpose of public offering, the investment banker and our client desire to use the appraisal figures on the balance sheet.

"In no statement or ruling do we find that the SEC explicitly refuses to permit the use of valuations by appraisal covering property having a true fair market value. In many instances we found references to appraisals of one kind or another. In the Thomascolor Case, the appraisals were apparently out of line. As we read it, the SEC's criticism in that case was not leveled against the use of appraisals per se, but was directed at the type of appraisals and the question of adequate disclosure.

"The attorney for our client joined us in a conference in Washington last week with a representative of the SEC who made the statement that they would not recognize appraisals of any kind, and would require that any increase in value be deleted from the balance sheet. Their informal answer was 'no appraisals of any kind, period.' We received quite a dissertation as to the efforts of the SEC and the Institute to agree on some manner of reporting or even proscribing appraisal valuations. Their attitude appears to be that in the absence of some agreement, no appraisal values may be used.

"We are wondering what the experience of other members of the Institute has been on this question. We would also like an estimate of the various possibilities in the event the balance sheet showing appraisal values is submitted."

Our Opinion

Hearsay is that the experience of other Institute members on this question has been the same as yours.

You also ask for "an estimate of the various possibilities in the event the balance sheet showing appraisal values is submitted." We suppose that in such event, after the registration statement had been examined by the Commission's staff, the SEC might issue a memorandum of comment or "Deficiency memo" suggesting changes in or additions to the material originally filed. At this point, you would ordinarily have an opportunity to discuss the Commission's suggestions informally with the Commission's staff. If the registration statement is not appropriately corrected by amendment, the Commission might then exercise its "stop-order" powers and refuse to allow the statement to become effective until it is amended.

It seems to us that in the situation described, the proper accounting treatment should not be made to turn on the fact that (as you state) "the investment banker and your client (the transferor) *desire to use* the appraisal values on the balance sheet for the purpose of a public offering." The burden of sustaining the use of appraisal values would either be less difficult – or more difficult if not impossible –depending on whether the basic transaction is construed as a "purchase" or a "pooling of interests" – also whether the relations or negotiations between the parties are arm's-length, and whether there is a continuance of beneficial interest in the property transferred. If appraisal values were to be given any regard at all, then who does the appraising, of course, and in what manner, is another important consideration. In this latter connection, the following passage from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at pp. 249-50) will be of interest to you:

> Standards of the Securities and Exchange Commission. – The Securities and Exchange Commission has issued stop-orders when, on investigation, it found that so-called appraised values expressed in balance sheets did not meet certain standards. The Commission insists that an appraisal must be more than an arbitrary determination and must be based on scientific methods; that the appraiser must be in fact independent; and that there must be a fair and accurate application of the methods purported to be followed. Even though valuations are in the final analysis expressions of judgment, the Commission does not consider that this warrants departure from these standards. The Commission holds that a balance sheet containing an untrue statement through over-

valuation of an asset is not acceptable even if a footnote discloses the overvaluation. The Commission has not criticized downward restatements of plant costs, but has been disinclined to accept upward restatements.[1]

For some further explicit indications of the SEC's policy respecting writeups to appraisal or replacement values, see *Accounting Series Release No. 8, Creation by Promotional Companies of Surplus by Appraisal* (1938); the discussion at p. 26 *et seq.* of L. H. Rappaport's *SEC Accounting Practice and Procedure* (Ronald Press Co., N.Y., 1959) under the heading "Accounting for Property and Appraisals"; and the case involving an attempted writeup of assets discussed at p. 339 of *Securities Regulation,* by Louis Loss (Little, Brown & Co., Boston, 1961, vol. 1). Also, in an article on "SEC Accounting Requirements" in *The Florida CPA* for May, 1962, Carman G. Blough,

[1] For a good summary of the Institute's views generally with respect to writeups in the value of assets, see the first half of Carman G. Blough's reply in the item, "Auditor's Responsibility When Asset Values Are Written Up," which appeared at pp. 348-9 of the September, 1953 issue of *The Journal of Accountancy.* Also, see the reference to the 1945 resolution of the Institute's Committee on Accounting Procedure in the item, "Is This an Occasion for Upward Restatement?", which appeared at pp. 346-7 of the March, 1953 issue of *The Journal.*

Regarding possible alternative methods of presentation, see first paragraph of "Answer" at p. 251 of the September, 1948 issue of *The Journal,* and the item "Footnotes in Annual Reports Disclose Appraisal Values of Fixed Properties," at p. 467 of the October, 1951 issue of *The Journal.*

Although scores of articles have been written on the subject of revaluation of assets, see in particular the ff.:

1. "Some Legal Problems Arising from Profit Determination in Periods of Rising Prices," by W. A. Kiley (in *University of Cincinnati Law Review* for Fall, 1955, at pp. 519-54). See esp. under "The S.E.C. Attitude Toward Replacement Cost," etc., at p. 538 *et seq.*
2. "Why Not Retain Historical Cost?", by Eric L. Kohler (in October, 1963 issue of *The Journal of Accountancy,* at pp. 35-41).
3. *Supplementary Statement No. 1, Accounting for Land, Buildings, and Equipment,* by American Accounting Association's committee on concepts and standards – long-lived assets (in *The Accounting Review* for July, 1964, at pp. 693-9).
4. See the analysis on appraisal writeups by Harry H. Wade (in "Comments on Research Bulletins," at pp. 217-19 of *The Accounting Review* for April, 1962).
5. *The Measurement of Property, Plant, and Equipment in Financial Statements* [Summary of Proceedings of Harvard Business School Accounting Round Table, April 29-30, 1963 (pub. by Harvard Graduate School of Business Administration, Boston, 1964; reported by Robert T. Sprouse)].
6. *Reporting the Financial Effects of Price-Level Changes, Accounting Research Study No. 6* (AICPA, 1963).
7. "Price-Level Accounting" [section 1, pp. 7-18 in *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1962)].

former Chief Accountant of the SEC, makes the following statement (at p. 21), viz.:

> The general policy of the Commission since its inception has been that there shall be no writeups of assets above their cost to the registrant when originally acquired. There have not been more than two or three exceptions to this general rule and they were in peculiar cases in which the Commission thought the circumstances warranted departure from the general rule.

In the same article, see the discussion (at p. 19) under the heading "Appraisals."

Also noteworthy is the following statement by Edward Epstein, Senior Financial Analyst of the New York regional office of SEC, in the article "Financial Reporting Requirements in Regulation A Offerings" (appearing in the AICPA's Professional Development course, *Filings with the SEC*), viz.:

> (7) *Appraisals and Writeups* as a result of such appraisals are objected to on the principle that accounting should always be based upon cost. It is common for an enthusiastic promoter to assign a generous value to his company's assets equivalent to the par value of the stock certificates issued for them. Sometimes these are priced at the proposed offering price! Unless the cost to the transferring person can be established from his cash records or some other basis the staff will request deletion of any money values. Sometimes it is possible to use appraisals in specific situations such as where various assets are acquired by an issuer in a cash purchase and it is desired to assign component values based upon an appraisal of each of the items such as equipment, inventory, leasehold improvements et cetera. Sometimes the values may be determined from the market value of stock issued for such assets where the stock has established quotation records. In general, however, appraisal and writeups are discouraged.

Finally, see the article, "Disclosure Requirements Under Federal Securities Regulation," by Harry Heller, member of D.C. bar and formerly Assistant Director of the SEC's Division of Corporate Finance (in *The Business Lawyer* for January, 1961, pp. 300-20, esp. at pp. 307-10). After discussing the SEC's attitude regarding attempted prognostications of future earnings, with case citations, Mr. Heller states the following:

> Something must also be said about the property of an enterprise and its balance sheet valuation. Fairly frequently attempts are made to file financial statements with the Commission which include writeups of the book value of fixed assets on the basis of present reproduction costs or fair market value at a recent date. These appraisals the Commission has almost always considered to be misleading. They are opposed to the generally accepted accounting principle that fixed assets be shown at cost. Accountants wisely adhere to facts. Recorded cost is a fact; value is an opinion which varies with different viewpoints. Moreover, these valuations are meaningless if we accept the premise that corporations sell securities to continue in business and not to liquidate. As a corollary, valuations indicating present market value or present replacement costs are of no analytical value since it is not intended to sell the property or to replace it immediately but to use the property to carry on a business as a going concern. The ultimate market value, or replacement costs of the property at the time the company actually liquidates, may be a vastly different figure from the appraisal. Indeed, the property may not even exist at that time. Moreover, such appraisals are contrary to the capitalization of future earnings theory of investment value, which as I have said, is held by the great majority of economists, financial analysts and the courts. . . .
>
> It is therefore understandable why the Commission's forms of registration statements do not require or permit appraisals of the physical property of an enterprise.

Mr. Heller then goes on to discuss the exceptional case of the May Stores Realty Corporation (q.v. at pp. 309-10), but concludes (with cited case):

> That the May Stores Realty case is of little precedent making value is apparent from the fact that subsequently the Commission has refused to permit appraisals of real estate to be included in registration statements.

Inquiry **489** (translation from French)

Foreign accountant's inquiry respecting historical cost, revaluation of accounts, Lifo, etc., in United States

"Under the sponsorship of the National Belgian Fund for Scientific Research and the Paris National Center for Scientific Research, I am completing a doctoral thesis on 'the correcting of accounts.'

"I devote particular attention to a description of the legal regime of revaluation of accounts in the United States. I was able to note that fixed assets and amortizations are appraised (stated) on the basis of 'historical cost' whereas stock (inventories) may be appraised in accordance with the 'Lifo' system.

"I should like to know whether United States law has been moving towards using the replacement value as appraisal criterion of amortizations and fixed assets, and if so, what are the new provisions in force (contents and date)?"

Our Opinion

Since your letter has reference to legal rules governing revaluation of accounts in the United States, perhaps we should preface our remarks by stating that, apart from the realm of Federal taxation and the regulation of public utilities, there is very little codification of substantive accounting principles or procedures in statutes governing corporations organized in the various states. Some of the statutory provisions regarding capital and dividends have their impact upon questions of balance-sheet valuations and representations.

In the United States, we do not have anything comparable to, say, the *British Companies Act.* However, a considerable body of law relating to accounting matters may be found in judicial opinions or pronouncements.

Also, it should be stated that the Securities and Exchange Commission, a Federal body which regulates the listing and trading of securities on national securities exchanges, has had a considerable influence upon corporate accounting practices. All companies whose stocks are traded on national securities exchanges must file financial statements periodically in accordance with certain accounting requirements as laid down prinicipally in the SEC's Regulation S-X and in its Accounting Series Releases.

By and large, however, generally accepted corporate accounting principles, procedures, and presentation have been developed by organized groups of private and professional public accountants. The American Institute of CPAs, principally through its Accounting Research Bulletins, Accounting Principles Board Opinions, and other publications such as *The Journal of Accountancy* has made a primary and significant contribution to development of a recognized body of accounting conventions, or "generally accepted accounting principles."

In our opinion, one of the more enlightening publications for your purposes which has appeared to date is *The Law of Accounting and Financial Statements,* by George S. Hills (Little, Brown & Co., Boston, Mass., 1957, 338 pp.). This publication collates, interprets – and synthesizes and reconciles to some extent – accounting principles and divergent views thereof as expressed in statutes, court decisions, and administrative regulations, in authoritative accounting textbooks, and in the official publications of organized groups of accountants, particularly those of the American Institute of CPAs.

To advert to your specific question, generally accepted accounting principles in the United States still require more or less strict adherence to historical cost in recording assets on the balance sheet. There is always the necessity for a "writedown" or scaling down of carrying values when there is evidence of permanent impairment of useful value. Although instances of upward departures from cost or "writeups" occur, independent public accountants usually will take exception to such treatment unless they can satisfy themselves on some objective basis that a writeup is not merely arbitrary or whimsical. The Securities and Exchange Commission, mentioned above, prohibits most writeups as a practical matter, in statements filed with them. The Institute has not as yet published an Accounting Research Bulletin establishing criteria, if any, necessary to justify upward departures from cost. However, at this stage in the development of accounting, there is an unwritten caveat among independent public accountants against upward departures. This becomes more understandable when one considers certain excesses of the past.

What has been stated above does not mean that there has not been lively discussion among American Certified Public Accountants of the question whether accounts or statements should be adjusted to take into account changes in the purchasing power of the dollar. Until more recent decades, there was no particularly urgent reason for questioning the premise of a stable dollar which underlies financial presentation in the United States. It is well to bear in mind that ad hoc writeups of fixed assets to appraisal values or replacement cost which, based on a number of cases we have encountered, more often than not are colorable, contrived, or self-serving, are to be sharply distinguished from a thoroughgoing price-level accounting. We believe proponents of the latter recommend its adoption not out of expediency but because of a genuine belief that a different premise (the stable dollar rather than historical cost) be used for the accounts, and that *all* accounts be periodically *and consistently* adjusted in terms of the premise – naturally, there are serious pros and cons to this question also, but generally, the motives are pure.

It should be emphasized that we have been speaking of the use of historical cost *from the standpoint of periodic presentation of operating results and financial position.* Balance sheets prepared for the *special purpose* of purchase and sale of a business frequently contain asset accounts adjusted to appraised fair market value.

Although there has been considerable discussion of the pros and cons, there is as yet no significant trend in the United States towards actual use of replacement costs for depreciable assets and for purposes of depreciation accounting. However, as stated in your letter, the Last-In, First-Out (or Lifo) method of pricing inventories is deemed to be a generally accepted accounting principle or method. The fact that the method is allowed for tax purposes in a generally inflationary period is not the least of the reasons why it is "generally accepted." However, with the minimizing of the relative importance of the balance sheet that has taken place and the trend toward emphasizing the income statement and the proper determination of net income for the year, Lifo has been justified principally as a means of "matching current costs with current revenues." Actually, of course, the balance sheet and income statement are inextricably bound up with each other, and a purported refinement in one statement may sometimes introduce a distortion in the other statement.

The American Accounting Association, an authoritative group of accountants which counts most of the professors and teachers of accounting among its members, has published a pamphlet entitled *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements.* Supplementary Statements 2, 5, and 6 included within this pamphlet are quite relevant to your topic. They deal, respectively, with "Price Level Changes and Financial Statements," "Accounting Corrections," and "Inventory Pricing and Changes in Price Levels."

You will also want to know that the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) summarizes and discusses the pros and cons (with citations to American authorities) of "Historical Cost or Revaluation Figures as Basis of Accounting."

Special Note Regarding Upward Restatements

The foregoing correspondence (Inquiries 462-489) consistently and insistently stresses a position in favor of adherence to cost. At press time, *Opinions of the Accounting Principles Board No. 6, Status of Accounting Research Bulletins* (AICPA, October, 1965) was published. At page 42 thereof, the following explicit statement appears, viz.:

"The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity."

Parent-Subsidiary Relationships and Consolidated Statements

FIFTY-PER-CENT-OWNED COMPANIES

Inquiry **490**

Accounting presentation of fifty-per-cent-owned companies

"We would like your opinion on the proper handling of the following matter:

"Company A owns 50 per cent of the outstanding capital stock of Company B. The other 50 per cent is owned by an individual who is not related to Company A in any way. Company A invested $5,000 for its 50 per cent interest; they also have advanced $100,000 to Company B for working capital. Under the terms of an agreement between the two companies, Company A is to receive 35 per cent of the gross revenues of Company B, after which its loan is to be repaid before any distribution of profits can be made to the stockholders.

"Our question relates to the handling of the increase in the net worth of Company B in the statements of Company A. We propose to increase the investment account with a corresponding credit to the income statement for one-half of the net earnings after taxes of Company B.

"We would appreciate your comments and recommendations regarding the above treatment, and if it meets with your approval, we would also like your opinion as to whether or not there would have to be a segregation of Company B's earnings in the retained earnings of Company A until Company B actually declared and paid a dividend to Company A."

Our Opinion

In the first sentence of par. 2 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959), the Institute's Committee on Accounting Procedure endorses "over fifty per cent (ownership) of the outstanding voting shares" as a minimum criterion for the preparation of consolidated financial statements. As for 50%-owned companies, we have reason to believe that many if not most of the committee members who participated in writing the *Bulletin* would go along with the view that companies whose voting shares are owned 50 per cent by each of two companies are not "subsidiaries" of either of them as that term is usually defined, and, accordingly, that the accounts of a 50%-owned company should not be included in the consolidated financial statements. (Incidentally, we have heard of a few cases where 50%-owned companies have in fact been consolidated.) However, although *A.R.B. No. 51* does not expressly deal with 50%-owned companies, the committee did have some discussion of the matter when the *Bulletin* was in preparation, and based on what we know of such discussion, we believe many if not most of the committee members would consider it to be appropriate for each of two companies owning 50% of the voting shares of another company to take up its share of the undistributed earnings of the 50%-owned company in its accounts and financial statements in the same manner and with the same disclosure as applies to unconsolidated subsidiaries,[1] *provided that,* where the amounts involved are significant, separate financial statements of the 50%-owned company are furnished.

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1 See par's 19-21 in *A.R.B. No. 51.* For an excellent discussion of "50%-owned companies" which appeared subsequent to this exchange of correspondence, see the chapter entitled "Intercorporate Investments" at pp. 183-94 of *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1962).

The material *directly following*, illustrates varying treatments used in actual cases where investments are carried at equity in a 50%-owned company. Our personal view is that the portion of undistributed earnings of Company B taken up by Company A *should* be segregated or earmarked as such in the equity section of the latter company's balance sheet.

AICPA RESEARCH MEMORANDUM[2]
50%-OWNED COMPANIES

DEFINITION OF 50%-OWNED COMPANIES

The term "50%-Owned Companies" will be used to refer to situations where each of two companies owns directly or indirectly *exactly* 50% of the voting shares of a third company. Other terms which have been used are "50-50 Companies," "Associated Companies," and "Jointly-Owned Companies."

The most distinctive feature of this relationship is that neither of the parent companies technically has control of the third company. Thus, it differs significantly from a 51%-49% combination where control can be exercised by one company, and also from situations where voting control is divided equally among three or more companies, since two or more of the owners could combine to control the operations of the jointly-owned company.

The selection of the term "50%-Owned Companies" was made in part because, except for the word "approximately," it conforms closely to the usage of the Securities and Exchange Commission. Rule 1-02 of Regulation S-X defines a "Fifty-percent owned person" as "a person in respect of which the registrant owns directly or indirectly approximately 50% of the voting securities and approximately 50% of the voting securities of such person is owned directly or indirectly by another single interest."

A case which might be an exception to "exactly 50%" would be one where, say, 49% of the voting shares are held by each of two companies, with the small remainder being held by persons who never

[2] For this excellent collation and study of material dated August 15, 1960, we are principally indebted to the late Dr. Perry Mason, formerly Assistant Director of the AICPA's Accounting Research Division.

exercise their voting rights or are equally divided as to their affiliation or interests between the two principal owners. In a case of this general type which came to our attention, an intermediate holding company was set up to hold the 98% of the shares, with its shares being divided equally between the two parent companies.

Extent of the Use of 50%-Owned Companies

The use of 50%-owned companies has come to be fairly common in American business practice and appears to be increasing in importance. Among the 600 companies surveyed in the preparation of *Accounting Trends and Techniques,* well over 100 companies are involved in the joint ownership of around 300 fifty-per-cent-owned companies.

This arrangement has been used extensively by oil and chemical companies and to a lesser extent in steel, paper and other industries. It has been employed to serve a variety of purposes such as: to conduct research; to assure a supply of basic materials or services; to acquire adequate distribution facilities; to solve the problem of high cost or risk in comparison with the resources of any one company; or to meet the legal requirements of some foreign countries. In some cases the two owners carry on complementary operations; in others they are directly competitive.

SEC Rules

The treatment of 50%-owned companies in filings with the Securities and Exchange Commission is covered by certain rules and instructions.

Rule 4-02(a) of Regulation S-X provides that: "The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary." This would seem to rule out consolidation of a 50%-owned company.[3]

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[3] Editor's note: *But see* L. H. Rappaport's column in the November, 1964 issue of *The N.Y. CPA* at p. 838 *et seq.* The column entitled "The Unacknowledged Subsidiary in Consolidated Financial Statements" deals with the consolidation of so-called "satellite companies," with specific reference to the Atlantic Research Corporation case. *Inter alia,* the column states that "the principal point of the SEC decision involved the existence of a parent-subsidiary relationship by means of control exercised otherwise than by being the owner of record of the subsidiary's voting stock. The view was expressed that where such effective control exists, careful consideration should be given to the inclusion of the controlled subsidiary in the consolidated statements."

Instruction 7 of the Instructions as to Financial Statements for Form S-1 relates to the filing of financial statements of 50%-owned companies. It reads as follows:

> If the registrant owns, directly or indirectly, approximately 50 per cent of the voting securities of any person and approximately 50 per cent of the voting securities of such person is owned, directly or indirectly, by another single interest, there shall be filed for each such person the financial statements which would be required if it were a registrant. The statements filed for each such person shall identify the other single interest.

Rule 4-05(b) covers the reconciliation of the investment and the equity in the net assets of 50%-owned companies. It reads:

> A statement shall be made of the amount of any difference between the investment of the parent and its consolidated subsidiaries, as shown by their books, in the unconsolidated subsidiaries and fifty-percent owned persons for which statements are filed and the equity of such persons in the net assets of such unconsolidated subsidiaries, and fifty-percent owned persons, as shown by the books of the latter.

THE PROBLEM

The accounting problem is primarily how to indicate most effectively the relationship with the 50%-owned company and the results of its operations in the annual report to shareholders of each parent company. The principal questions to be considered (assuming materiality of the amounts) are:

1. Should the investment in the 50%-owned company be carried at cost, or should it be adjusted for half of the earnings or losses of the 50%-owned company? (There are variations in the procedure for doing this which will be discussed at a later point.)
2. If the investment is carried at cost, what are the minimum disclosures as to the share in net earnings or losses and in net assets of the 50%-owned company?
3. In any case, what additional disclosures should be made?
4. Should the financial statements of the 50%-owned company be consolidated with those of the parent, either in total or to the extent of 50% of each of the items?

Previous Consideration by Committee on Accounting Procedure

The problem of 50%-owned companies was given considerable attention by the committee on accounting procedure during its preparation of *Accounting Research Bulletin No. 51, Consolidated Financial Statements.* A paragraph on the subject appeared in several drafts of the bulletin but it was deleted just prior to the preparation of the exposure draft. The latest draft of this section read as follows:

> Companies whose voting shares are owned fifty percent (or approximately fifty percent) by each of two companies are not subsidiaries of either of them, and therefore cannot be included in the consolidated financial statements of either. However, it is appropriate for each of such two companies to take up its share of the undistributed earnings of fifty-percent-owned companies in its accounts and financial statements in the same manner and with the same disclosure as applies to unconsolidated subsidiaries. Separate financial statements of the fifty-percent-owned companies should be furnished where the amounts involved are significant.

Observed Variations in Practice

The annual reports of 102 parent companies, involving eighty-three 50%-owned companies, were examined, and a variety of practices was observed. Unless otherwise indicated, the examples are taken from 1959 reports.

I. *No indication in annual report of connection with 50%-owned company.* Our information as to the existence of a 50%-owned company was obtained from Moody's *Manual of Investments,* and was presumably based upon filings with the SEC. Undoubtedly, the omission of any reference to the 50%-owned company was frequently due to its lack of materiality, but sometimes sizeable investments were not mentioned. For example, the report of Standard Oil Company (N.J.) does not indicate that the company owns half of Ethyl Corporation with General Motors Corporation owning the other half. The report does provide some information on two more significant 50%-owned companies. Incidentally, the 1959 General Motors report shows that its investment in Ethyl Corporation is carried at $17,519,633, which, as indicated by an earlier report, was its cost adjusted for undistributed earnings to December 31, 1935.

II. *Investment in 50%-owned company carried at cost or less.* In most cases, the investment was carried at cost or less, but there was considerable variety in the nature and amount of the information disclosed.

a. Merely disclosed that the affiliation existed. Example – Pittsburgh Plate Glass Co. as to its 50% ownership of Koppers Pittsburgh Co.

b. Disclosure limited to the cost of the investment in 50%-owned companies:
   1. Individual company. Example – Allied Chemical Corporation – a footnote on investments indicates that the investments in Allied-Kennecott Titanium Corporation amounts to $1,350,000.

   2. Group of companies. Examples – Scott Paper Company has a 50% interest in Brunswick Pulp & Paper Company. Its report contains a three-column schedule showing "Investments at Cost 1959," "Equity in Estimated 1959 Earnings," and "Dividend Income 1959." Complete individual data are given for three foreign 50%-owned companies, but only the cost of investments is shown for an item labeled "Other Corporations" which presumably includes Brunswick Pulp & Paper Company.

c. Equity in undistributed current earnings of 50%-owned companies disclosed:
   1. Individual company. Example – Kennecott Copper Corporation presents a schedule of "Equity in Operations of Unconsolidated Companies" and, in the schedule, its half of the earnings of Garfield Chemical & Manufacturing Corporation is shown to be $514,500 in 1959 and $908,404 in 1958. The equity in the net assets was given only for a group as a whole. Also see Scott Paper Company procedure above.
   2. Group of companies. Example – Texaco, Inc. – a footnote breaks up the investment cost by groups of companies and says: "Texaco's equity in the estimated 1959 net earnings of nonsubsidiary companies and subsidiary companies not consolidated exceeded dividends received during the year by approximately $5,000,000, which has not been reflected in the consolidated statements." The equity in net assets is not given.

d. Disclosure of equity in net assets of 50%-owned companies but with no disclosure of equity in current earnings:

1. Individual company. Example — Allegheny Ludlum Steel Corporation — footnote: "The corporation's equity in the net assets of Titanium Metals Corporation of America (50%-owned company) in respect of the investment and advances aggregating $1,445,000 amounted to $12,400,797 at December 31, 1959."
2. Group of companies. Example — Champion Paper & Fibre Company — footnote: "The Company's equity in the net tangible assets of foreign affiliated and fifty-percent-owned companies at December 31, 1958 . . . exceeded by approximately $2,500,000 the Company's investment therein."

e. Disclosure of equity in both current earnings and net assets. Example — Stauffer Chemical Company. "Dividends received from the associated companies amounted to $1,445,465 in 1959 and $1,132,500 in 1958. Based on unaudited financial statements, the net earnings of the associated companies applicable to the shares owned by the Company amounted to $1,344,556 in 1959 and $1,566,424 . . . in 1958, and at December 31, 1959 the underlying net assets applicable to such shares exceeded the cost of the shares to the Company by $605,676."

III. *Investment carried at equity in 50%-owned company.*

a. Current income taken upon balance sheet, income statement and in earned surplus. Example — Atlas Powder Co. — footnote: "The investment therein . . . is carried in the consolidated balance sheet at underlying net asset value. Atlas' share of the net income of these companies (less income tax which would have been payable thereon if received as dividend), $472,000, has been included in consolidated earnings for the year and in consolidated retained earnings at December 31, 1959." The equity in the current earnings of the 50%-owned companies appears as a specific item on the income statement.

b. Current income added to investment, but credited to a special surplus account, similar to the treatment by du Pont of its investment in General Motors stock. The example closest to this practice was found in the 1958 annual report of Ayrshire Collieries Corporation. The balance sheet shows under "Investments" — "Investments in and advances to affiliated companies (owned 50% or more) — Capital Stock at underlying book value . . ." and, as a special surplus item under "Stockholders' Equity" — "Equity in undistributed net income of affiliated companies." The income statement shows an item of "Equity in undistributed net income of affiliated companies" but it is not a part of the "Balance of Net Income" which is transferred to the statement of earned surplus; it is instead added to that figure to arrive at "Net Earnings, including equity in undistributed net income of affiliated companies." In 1959, this company included the equity in earnings of 50%-owned companies in the calculation of net income for the year carried to earned surplus.

c. Current income taken up both in balance sheet and income statement, but undistributed earnings segregated on the balance sheet. Example – Peabody Coal Co. The balance sheet shows a special surplus item: "Equity in undistributed earnings of 50%-owned companies." The statement of retained earnings shows a deduction: "Undistributed earnings of 50%-owned companies included in net income (segregated on balance sheet)." The equity in current earnings of 50%-owned companies does not appear as a specific item on the income statement.

IV. *Consolidation of 50% of each item on financial statements of 50%-owned company.*

a. Presented as supplementary or statistical schedule. Example – Monsanto Chemical Company. The schedule heading is: "Shareowners' Net Interests in Parent Company, Domestic and Foreign Subsidiaries and 50%-Owned Associated Companies, Consolidating Only that Percentage of Associated Companies Which is Represented by Monsanto Shareowners' Equity." In the primary financial statements, the investment in 50%-owned companies is carried at cost and there is group disclosure of the equity in current earnings and in net assets.

b. Presented in consolidating or combining three-column statement. Monsanto Chemical Company in its 1960 annual report will present its principal financial statements, covered by its auditor's report, in columnar form. The following headings were used in the March 31, 1960 interim statement: "The Company and Subsidiaries Consolidated," "The Company's Proportionate Share of Fifty Per Cent Owned Companies" and "Combined Total." A footnote to the balance sheet reads as follows: "All intercompany transactions have been eliminated in the above statement and in the accompanying statement of income. As a result, the columns do not necessarily add to the combined totals."

V. *Other variations in disclosure.*

a. Financial statements of 50%-owned companies presented in the annual report of the parent company. Example – American Viscose Corporation included in its annual report a condensed balance sheet of Chemstrand Corporation, which showed the net income for the year. In its six-months interim statement, dated July 22, 1960, the comments section of the report contained statistical data for sales, net earnings, and earnings per share in which the amounts for American Viscose and 50% of the corresponding figures for two 50%-owned companies were combined.

b. Financial statements of 50%-owned company distributed to the shareholders of the parent company as a separate document. Example – Monsanto Chemical Company distributed the annual report of Chemstrand Corporation to its shareholders.

c. Dividends received from 50%-owned companies indicated. Example – Scott Paper Company.

d. Name of other parent indicated. Example – National Lead Company. "National Lead Company and Republic Steel Corporation are joint owners of the R-N Corporation which was organized to develop and license a process for the recovery of iron by direct reduction of ore."

e. Significant details of agreement between the two parent companies. Example – Armco Steel Corporation – footnote: "The Company owns 50% of the capital stock of Reserve Mining Company, the other 50% being owned by Republic Steel Corporation. The two shareholders are obligated (until the outstanding $127,493,000 principal amount of 4¼% First Mortgage bonds due June 1, 1980 of Reserve is paid in full) to take the entire production of Reserve, and as to each half-owner, to pay 50% of Reserve's operating costs and interest charges. If and to the extent that Reserve shall not have made the necessary payments, each shareholder is also obligated to pay one-half of amounts needed by Reserve for (a) fixed sinking fund requirements on the said bonds and (b) certain future capital replacements."

Inquiry **491**

Transfer of lands by subsidiary to joint venture, in consideration of cash payment and capital credit, each computed at 50 per cent of fair market value of lands

"Your opinion is desired with respect to the treatment on the consolidated financial statements, of certain transactions entered into during the year under examination.

"The parent company is substantially a holding company with subsidiaries whose principal activities are the purchase, development and sale of land.

"1. During the year under examination a wholly-owned subsidiary entered into a joint venture with a developer whereby the subsidiary transferred all its lands to the joint venture. The company holds a 50 per cent interest in the capital and profits of the venture. In consideration for the lands transferred, the subsidiary company received a capital credit in the joint venture of one-half the market value of the lands transferred and the remainder in cash.

"The subsidiary company on its statements reflects its investment in the joint venture at the amount of the credit it received on the joint venture's books (50 per cent of the market value of the lands transferred), and the difference between the cost of the proportionate share (50 per cent) of the land so transferred and the market value thereof as unrealized appreciation under the stockholders' equity section of the balance sheet.

"In consolidation with the parent company, should the unrealized appreciation be eliminated with a corresponding reduction in the carrying value of the investment in the joint venture?

"2. During the year two wholly-owned subsidiary companies sold all their lands for cash, and under a plan of liquidation filed proper papers for dissolution. The subsidiary companies are in the process of dissolution at the balance-sheet-date of the parent company.

"The parent company, in consolidation, proposes to include the gain realized by the subsidiaries from the sale of their lands as a special credit at the bottom of the income statement as gain from liquidation of subsidiaries.

"In view of the fact that the subsidiaries are but a corporate shell and are formed at will to acquire and develop real estate and the subsequent resale thereof, it appears that the company might be justified in reflecting the gain as proposed."

Our Opinion

1. We have not been able to find a discussion in the accounting literature examined of the specific question raised in the fifth paragraph of your letter.

However, in our opinion, the fair market value attributed to the lands transferred to the venture has some objective basis in fact and is not merely an arbitrary or whimsical value. We draw such conclusion in this particular case on the ground that the other joint venture was actually willing to pay one-half the imputed value *in cash*. The over-all value is further corroborated by the one-half capital credit the other joint venturer was willing to grant, to match his own one-half interest. We do not believe that elimination of the unrealized appreciation and corresponding reduction in the carrying value of the investment in the joint venture is *required* in preparing the consolidated statements.

The unrealized appreciation should, of course, be properly identified in the consolidated balance sheet, and if material in amount, the rule of informative disclosure would, in our opinion, require footnote explanation of the circumstances under which it arose.

We also believe serious consideration should be given to the necessity of reducing the investment account by an allowance for the amount of the tax applicable to the appraisal increment. In other words, if the tax basis of the investment is materially less than its recorded value on the subsidiary's books, should not such fair value be "discounted in advance" by the amount of the tax estimated to be payable upon ultimate liquidation of the investment at its carrying value? See *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 158, 160, and 500, and *op. cit.*, 1949 edition, at pp. 139, 141, and 238-9. If a tax allowance is set up, the corresponding debit would be made to the unrealized appreciation account.

Personally, we would be more comfortable if the subsidiary used a "cost-recovery" procedure in accounting for its transactions with the joint venture. If such a procedure were followed, upon transfer of its lands to the joint venture in consideration for cash and a capital credit computed at 50 per cent of the estimated fair market value of such lands, the subsidiary would record the receipt of the cash and set the investment in the joint venture up at an amount representing the difference between the cost of the lands transferred and the cash received. Thus, instead of being measured and carried forward in terms of the client's underlying equity in the venture, the investment would be stated at the *unrecovered cost of lands transferred* to joint venture. In a situation where the estimated fair value exceeded twice the cost of the land and accordingly, the cash received upon transfer exceeded cost, then a profit would have to be reflected. In such case, the investment and unrealized appreciation would have to be set up either at a nominal value or at underlying net equity in the joint venture, reduced by the estimated tax payable upon realization of the investment.

2. Regarding your second question, we would be inclined to regard the parent company's proposed presentation as acceptable since the subsidiary companies are in process of dissolution at the balance-sheet date of the parent company, and since, in any event, the gains realized by the subsidiaries upon sale of all their lands would be included in the consolidated income. The special credit treatment would also highlight the fact of the liquidation of the subsidiaries. However, if the dissolutions have not been given final effect by the date of your report, such fact should be disclosed in a footnote to the statements.

INTERCOMPANY TRANSACTIONS

Inquiry 492

Necessity for eliminating interdivisional profits and losses and account balances

"We have issued an unqualified opinion report for several years to one of our corporate clients in the publishing business. This client recently purchased an out-of-state commercial printing and greeting card sales organization. Assets purchased included paper stock inventory, machinery and equipment, name, trade-marks, customers, etc. The purchase price was substantially in excess of book value. It is the intention of our client to set up two separate divisions: a commercial printing division and a greeting card sales division. Our client is viewing all three operations separately and expects operating results from each one: the publishing division, printing division, and greeting card sales division.

"The interdivision transactions will consist of the following:

a. The commercial printing division will sell some printing work to the publishing division, but not in substantial amounts in relation to either set of books.
b. The commercial printing division will sell substantial printing work to the greeting card sales division.

"Management intends to make all interdivision billings at a competitive price.

"Since the purchase date, it has been discovered there is actually some ill-will attached to the names of the printing and greeting card sales divisions. A change in the name of both divisions is contemplated.

"We have indicated to the client that interim financial statements prepared by them may reflect all interdivision sales, receivables, payables, etc., as they wish. We have, however, expressed the opinion that our audited year-end statements must eliminate all interdivision balance-sheet accounts, sales, purchases, etc. Thus, for instance, their final sales volume will not include any interdivision sales.

"Our client is not wholly in accord with this view, and is skeptical that these principles are applied in the large corporation statements, such as Ford Motor Company and all its divisions.

"Would you please advise us on the following questions:

"1. Is it proper to eliminate all interdivision profits and losses by:

a. Reversing all interdivision sales and purchases, or
b. Leaving the sales and purchases overstated, which would not affect the final profit and eliminate only the profit remaining in inventories?

"2. Inasmuch as the names are about to be changed and it is not possible to find any other intangible assets of substantial value, what disposition should be made of the excess over book value (market value is about the same) which we are now calling good will?

"3. Will the acquisition of these two divisions, engaged in different activities, require any special changes in the wording of our opinion or presentation of financial statements in order to call attention to their consolidation with the original publishing company?

Assets will of course be larger and a note payable with appropriate description will appear.

"4. We have not been able to locate any references which deal with current and accepted practices in connection with *divisional accounting*. Can you suggest any?

"5. Does our firm have any problem if it is decided that we should perform the audits on these out-of-state divisions? We are wondering if it would be necessary to register with the State Boards of Accountancy, etc."

Our Opinion

We will attempt to answer your questions in the order asked.

1. It would be patently improper for regular year-end financial, i.e., external reporting purposes, not to eliminate interdivisional balances and transactions in the same manner and to the same extent that such balances and transactions are eliminated when preparing consolidated or "combined" statements.

In discussing "Consolidation Procedure Generally," *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959, at pp. 42-3), states:

> In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single business enterprise, such statements should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applied for this purpose is gross profit or loss.[1]

If then, one changes "intercompany" in the foregoing passage to read "intracompany" or "interdivisional" and changes "transactions

[1] The passage which follows this excerpt is also of considerable interest, viz.: "However, in a regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry."

among the companies in the group" to read "transactions between divisions of the company" – the requirements are fully as applicable to the statements in question as they are to consolidated financial statements.

We believe it would be erroneous to leave interdivisional sales and purchases overstated, i.e., not to reverse such interdivisional sales and purchases.

What has been stated above does not, of course, deter the company in any way from pursuing its policy of making interdivisional billings at competitive prices and reflecting the results of such policy in divisional statements used for internal reporting purposes.

For that matter, you may want to consider the desirability of preparing a so-called consolidating or combining income statement for regular financial reporting purposes. As we visualize such a statement, the results of operations as ordinarily reflected for internal reporting purposes might be set forth for each division (in three separate columns), a fourth column would reflect eliminations of interdivisional purchases, sales, and profits, and a final column would reflect (i.e., "present fairly") the combined results of operations of the company after appropriate eliminations. If such a statement were to be used, we believe the CPA should carefully limit his opinion as to fair presentation of results of operations to the final or combined column.

2. Paragraphs 8, 9, and 10 at pp. 39-40 of *Accounting Research Bulletin No. 43* (AICPA, 1953) should be your guide in dealing with the excess of purchase price over book value. If the premium payment was made for goodwill, and evidence now indicates that ill-will in fact attaches to the purchased name and trade-marks, the excess should be charged off either in the income statement or against earned surplus, depending on materiality (see esp. par. 8 at p. 39, and par. 11(d) at p. 63, of *A.R.B. No. 43*).

3. In the absence of a footnote to the financial statements disclosing certain essential facts concerning the acquisition of the two divisions, we believe the rule of informative disclosure would require your succinctly describing the facts in a separate paragraph of your report.

4. One excellent reference covering interdivisional accounting is the pamphlet entitled *Accounting for Intra-Company Transfers* [*NACA* (now NAA), 1956]. We believe you will be interested in perusing same. Incidentally, we note that Ford Motor Company participated in this study. Note especially par's 1 and 2 on p. 37 there-

of, referring to elimination of interunit profits and account balances.

5. The answer to this question depends on the state or states involved. The *Accountancy Law Reporter* (Commerce Clearing House, Inc., Chicago) which the AICPA's library has, but does not circulate, contains information, by states, on the laws and regulations governing the practice of public accountancy, particularly such matters as temporary practice, reciprocity, residence or place of business requirements, etc. It also lists the addresses of all State Boards of Accountancy.

Inquiry 493

Consolidated statements — elimination entry for intercompany profit on sale of fixed assets

"We have a question regarding the proper elimination entry to make in the preparation of consolidated statements. We have examined several standard textbooks on accounting without arriving at a definite answer. We would appreciate it if you would be good enough to give us an opinion.

"Company P, the parent, sells fixed assets to Company S, a wholly-owned subsidiary, at a profit. Assuming that the transaction is made as of the date of consolidation (so that depreciation to the subsidiary does not enter into the question), the question is: What is the elimination entry to eliminate the intercompany profit on the sale?

"Two alternatives suggest themselves:

1. Surplus (P)
   Fixed assets (net) (S)
2. Income (P)
   Fixed assets (net) (S)

"In other words, is the debit elimination made directly against consolidated surplus, or is it made first against consolidated income (and hence against surplus when consolidated income is closed to consolidated surplus)?

"If the sale and purchase were in income and expense of both companies, the elimination entry would be against sales and purchases in the income statement. But in the instant case, one company credits income with the sale and profit thereon, while the buying company charges a fixed asset.

"Additional questions are:

"Assuming the profit is to be eliminated, need the sale and purchase also be eliminated?

"Assuming the parent company is selling out of inventory rather than out of fixed assets, would the answers to the above questions be different?"

Our Opinion

Regarding the principal questions raised, we believe your first alternative would be the proper entry to eliminate the intercompany profit on sale of fixed assets, under the following circumstances:

a. When a consolidated balance sheet *only* is being drawn up at the end of the year in which the intercompany sale of fixed assets takes place, or
b. When making adjustments to eliminate intercompany profit in a year subsequent to the year in which the transaction took place.

On the other hand, we believe your second alternative would be the proper basic entry if *all* the customary financial statements (i.e., balance sheet, profit and loss, and surplus, statements) are being drawn up on a consolidated basis at the end of the year in which the intercompany sale of fixed assets takes place. A variation of your second alternative would be the following entry in the consolidated working papers or consolidating work sheet:

Dr. Proceeds — Sale of Fixed Assets to S	xxx	
Cr. Cost (net of accumulated depreciation) of Fixed Assets Sold to S		xx
Fixed Assets (gross) [or Allowance for Intercompany Profit in Fixed Assets]		x

We have cast the entry in the foregoing form because we believe it illustrates what the elimination entry should be (assuming *all* consolidated financial statements are being drawn up at the end of the year in which the transaction occurred) if Company P had recorded the proceeds and cost of the fixed asset sale in separate accounts on its books rather than only the gross profit on the transaction. Thus, regarding the next to last question in your letter, the answer seems to be that if the full sales proceeds are recorded by Company P in a separate account (rather than directly crediting the fixed asset account with a portion of the sales proceeds and crediting a special income or gain account for the remainder), then the sale and cost of such sale should be eliminated, but only the profit element attaching to the purchase cost recorded on the books of Company S should be eliminated.

Regarding your last question, the answer is "essentially, no." Karrenbrock and Simons, in their *Advanced Accounting – Comprehensive Volume* (South-Western Publishing Co., Chicago, 1955, p. 429) state:

> The practices that are followed in eliminating profits on the intercompany sale of inventories are equally applicable upon the intercompany sale of properties other than inventories.[1]

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[1] The Karrenbrock and Simons reference contains as clear an explanation of intercompany profit eliminations as any we have seen. [See at p. 420 *et seq.* and p. 429 *et seq.*; see also items (b), (c), and (g) on p. 536, relevant elimination entries on pp. 538-9, and items (b), (c), (c1), (c2), and (g) on pp. 541-3.]

The following publications also bear out the conclusions we have expressed above:

1. *CPA Review Manual,* by H. E. Miller (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1956). See pp. 342-9 and esp. pp. 365-6.
2. *Consolidated Statements,* by G. H. Newlove (D. C. Heath & Co., Boston, 1948). See pp. 233-5.
3. *Consolidated Financial Statements – Principles and Procedures,* by W. H. Childs (Cornell University Press, Ithaca, 1949). See pp. 147-8.
4. *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, ed. Wixon). See pp. 23.26-32 and 23.45-6, esp. under "Intercompany Sales of Fixed Assets" at p. 23.46.

Inquiry **494**

Consolidated statements — elimination of intercompany pipeline facility charges

"We have as a client a public utility which has a wholly-owned subsidiary. A list of pertinent facts and elimination entries for preparation of consolidated financial statements, follows.

"Based on the facts and elimination entries set forth, we would like to have an answer to the following question: If elimination entry C were not made, what effect would that have on the financial statements and the accountant's report? Would a footnote or some disclosure in the accountant's report have to be made? Naturally, we would prefer neither footnote, comment, nor qualification in the audit report.

FACTS

"1. The parent company is a gas distribution public utility which distributes natural gas within an urban area.

"2. The wholly-owned subsidiary is a gas transmission system. It transmits natural gas to the parent company's system. The subsidiary also distributes gas purchased from the parent to a few industrial customers.

"3. The subsidiary makes facility charges to the parent for the transmission of natural gas. The charges were arrived at by the two separate regulated companies and were subject to prior approval by the State Corporation Commission, and are at customary industry rates.

"4. Following is some current financial data of these companies. It is expected that the subsidiary will continue to grow and may exceed the parent in size in time.

	PARENT	SUBSIDIARY
Total Assets	$2,700,000	$445,000
Operating Revenues	1,800,000	145,000
Operating Expenses	1,700,000	107,000
Net Income after Income Tax	123,000	21,000

"5. The elimination entry in question is number C, having to do with the elimination of the pipeline facility charge from the subsidiary to the parent.

"6. The client's position is that elimination entry C is not necessary since there is no doubling up between the two companies such as the doubling up of revenues eliminated by entry B."

INQUIRY: **494**

ELIMINATION ENTRIES FOR CONSOLIDATION

	Debit	Credit
(A)		
Capital Stock (Subsidiary's books)	$135,000	
Investments in Associated Companies (Parent Company's books)		$135,000
To eliminate the investment in subsidiary's capital stock.		
(B)		
Operating Revenues (Parent Company's books)	85,000	
Operating Expenses — Gas (Subsidiary Company's books)		85,000
To eliminate intercompany sales and purchases of gas.		
(C)		
Operating Revenues (Subsidiary Company's books)	30,000	
Operating Expenses — Gas (Parent Company's books)		30,000
To eliminate inter-company pipeline facility charges.		
(D)		
Accounts Payable (Subsidiary Company's books)	7,000	
Accounts Receivable — Customers (Parent Company's books)		7,000
To eliminate inter-company trade account balances for gas at December 31.		
(E)		
Accounts Payable (Parent Company's books)	3,000	
Other Accounts Receivable — Miscellaneous (Subsidiary Company's books)		3,000
To eliminate inter-company trade balances (for pipeline facility charges).		

Our Opinion

If elimination entry C were not made, it is quite clear to us that this would be an error of omission and contrary to generally accepted accounting principles. Failure to make the elimination quite obviously would inflate the Operating Revenues and Operating Expenses of the consolidated entity by $30,000. The final figure for consolidated Net Income after Income Tax would not be affected. As to the propriety of making the elimination, we believe the discussion at pp. 23.46-7 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) definitely supports the foregoing conclusion.

In our opinion, the reason advanced by the client in support of its position, viz., "that elimination entry C is not necessary since there is no doubling up between the two companies such as the doubling up of revenues eliminated by entry B," lacks merit. Would the client by the same token abandon the generally accepted practice of eliminating intercompany dividends and interest which do not involve a "doubling up" but rather, just as in the case of intercompany rental charges, a mere transfer of cash from one constituent company included in the consolidated entity to another constituent company so included?

You also ask what effect failure to make elimination C would have on the accountant's report. It seems to us that the aforementioned effects on the operating statement are not sufficiently material to require either "necessary explanation" or disclosure and qualification in the accountant's report. We base this conclusion on the fact that even if perchance the *consolidated* statement of operations (rather than the separate statements) is scrutinized for regulatory purposes, it does not appear that any significant implication would attach to the fact that, with elimination C being made, the ratio of consolidated net income to consolidated operating revenues $\left(\frac{144}{1915}\right)$ is approximately 7.5 per cent, whereas with elimination C *not* being made, the ratio $\left(\frac{144}{1945}\right)$ becomes 7.4 per cent.

Inquiry **495**

Subsidiary operating its facilities in, and utilizing plants of, its two 50 per cent corporate owners — intercompany billings and charges

"I am proposing the following problem to you, seeking an answer to this problem.

"The problem is the legal interrelationship of major stockholders and the subsidiary, and the accounting necessary for recording these interrelationships. Specifically what constitutes a sale between these two entities, and how should these transactions be handled on the books of each?

BACKGROUND

"This corporation has its engineering facilities in the plant of a major stockholder (50 per cent) which also operates in this plant; and has its production facilities in the plant of another major stockholder (50 per cent) which also operates in that plant. Both plants are in the same industrial park. In order to conserve personnel, the accounting for both facilities is handled at the production plant. The majority of the costs (95 per cent of the manufacturing and other costs) of the subsidiary corporation in question, are incurred on the books of the two stockholders and are then billed monthly to the subsidiary. Effectively, all payroll costs are handled by the two major stockholders. Every effort is made to keep these costs separate. The subsidiary (this corporation) has its own general ledger, etc.

"During this slack period, this corporation has had some of its personnel performing service-type activities – clean up, tool inspection, filing for administrative departments, etc., – for the production stockholder. This work is not related to this subsidiary corporation's normal operation of constructing power supplies, and it has agreed to bill only labor costs, i.e., it will absorb other expenses as a loss.

"The major stockholder (production) has been billing the subsidiary for factory space (on the basis of actual space), factory service (on the basis of direct labor incurred in relationship to the total direct labor incurred by both major and subsidiary within the plant), and general and administrative expenses (on the basis of total manufacturing costs of both to the total G. and A. incurred).

QUESTIONS

"1. How should the subsidiary corporation handle the billing of labor performed in these service-type activities? Are these sales, or other income; where may these be shown on the profit and loss statement? Internally, may this work be considered direct labor by the subsidiary and overhead applied on this basis so that customer jobs will not have to absorb the burden?

"2. How should the major stockholder treat its billing of factory space and services, and its billing of general and administrative expenses? Is it justified in billing factory services on direct labor as above; and general and administrative expenses on total manufacturing costs as above, or must it use a fixed charge each month?

"3. Are these transactions at arms-length from the facts given, and may we stand upon this in defense of our position to government and public auditors? Would there have to be a wider division of facilities, services, etc., for us to be considered as separate and distinct? If so, what must the division be? (Note: There is no consolidation of statements.)

"We are writing not to circumvent our normal public auditors (an international accounting firm) because we have asked their judgment in this matter. Lately, we have been undergoing constant pressure by government auditors to consider the production major stockholder and the subsidiary in this plant as one in computation of costs, profits, overhead, renegotiable sales, etc. We feel that the gap is wide between each and treat them in the manner of separate legal persons which they are in fact. They produce entirely different products."

Our Opinion

We will try to answer your specific questions more or less in the order in which they are asked.

1. It is not clear from the third paragraph of your letter whether the direct labor costs of the subsidiary are accumulated and recorded on the books of the subsidiary in the first instance, or recorded on the books of the "production stockholder" in the first instance and subsequently billed as direct labor costs to the subsidiary. We assume it is the latter, since you state that "95 per cent of the manufacturing and other costs . . . are incurred (recorded?) on the books of the two stockholders and are then billed monthly to the subsidiary." We assume further that for the slack period in question, the production stockholder will not bill the subsidiary *net* of the service-type activity costs but will bill the subsidiary for the gross payroll costs attributable to the subsidiary's direct labor personnel, and moreover, will base its billing to the subsidiary for "factory services" (I.M.E. or Manufacturing Burden) on the ratio of gross payroll costs attributable to the subsidiary's direct labor personnel to total direct labor incurred – irrespective of the fact that some of the subsidiary's direct labor personnel has been engaged in service-type rather than production-type activities.

If our assumptions fit the facts, the total direct labor costs billed to the subsidiary would be recorded as such on the subsidiary's books and a corresponding liability to the production stockholder recognized for wages paid in its behalf. Accordingly, when the subsidiary bills back to the production stockholder the costs of performing service-type activities, *one way of handling* the accounting would be to credit the previously-recorded direct labor costs with the amount of the billing. The corresponding charge would then either be set up as a receivable from, or be used to reduce the subsidiary's liability to, the production stockholder. This treatment in which the labor cost of performing service-type activities is not ultimately reflected in the subsidiary's profit and loss statement *assumes* that the employees engaged in performing such activities are the employees of the production stockholder when performing same. However, if the employees performing service-type activities during the slack period are in fact employees of the subsidiary or are assumed to be such for accounting purposes, then when the subsidiary bills back the costs of performing service-type activities, the transaction may properly be regarded as performance of a service contract providing for reimbursement only for direct labor costs incurred. Viewed this way, the subsidiary's profit and loss statement should then show a Special Reimbursement from Parent for Services performed in its behalf, as a separate item of revenue in its profit and loss statement, with an equivalent allocated portion of total recorded direct labor costs deducted therefrom.

Furthermore, if the percentage of labor costs incurred in performing service-type activities to total "direct labor" costs assessed is not negligible, the subsidiary's cost of production or cost of sales should be relieved by a proportionate amount of the total factory service (manufacturing burden) costs assessed. In our opinion, such amount may properly be reflected in the profit and loss statement as a separate item of unabsorbed manufacturing burden.

2. In our opinion, the production stockholder should reflect its billing for factory space as rental income from subsidiary in its profit and loss statement. Also, its billings for factory services (i.e., for a portion of manufacturing overhead) and for a portion of general and administrative expenses incurred, should be separately reflected in the profit and loss statement as accrued revenues for services performed in behalf of its subsidiary. These special types of intercompany revenue may be shown short on the statement with the associated costs

involved deducted therefrom. An alternative treatment whereby the production stockholder would directly credit the respective amounts billed to the subsidiary, to the several categories of cost and expense involved, would have to be justified on the basis of what we consider to be a *fiction*, viz., that factory space utilized by the subsidiary is owned and *not leased* by the subsidiary, and that factory service costs and G. and A. expenses allocable to the subsidiary are directly incurred by the subsidiary and *not by the parent in behalf of* the subsidiary.

On the basis of information contained in your letter, we are obviously not in a position to state whether the production stockholder is justified in using the particular allocation or billing bases in question. Direct labor dollars (or hours) is an acceptable allocation basis in certain circumstances; also, total manufacturing costs may be as fair a basis as any in allocating General and Administrative expenses which are more or less "joint" in their incidence. For a helpful guide in determining whether a particular basis of allocation is appropriate in the particular circumstances, see under the heading "Overhead Formulas and Their Application," at pp. 1019-48 of the *Cost Accountants' Handbook* (Ronald Press Co., N.Y., 1944, ed. by Lang). This material lists "advantages and disadvantages" of the direct labor dollar, direct labor hour, machine hour, material cost, unit overhead costs on point basis, and prime costs methods.

3. On the basis of the facts given which apparently indicate that adverse parties or adverse interests are not involved in the (intercompany) transactions in question, it seems obvious to us that the said transactions are not made at "arms-length." However, the fact that a transaction is not an arms-length transaction does not raise a conclusive or irrebuttable presumption that it is not equitable as measured by available commercial standards or other criteria, or that it necessarily must be disregarded as sham. However, since non-arms-length transactions are not characterized by the built-in safeguards which are incident to truly-bargained transactions, we personally believe that from the vantage point of an adverse outside party, such non-arm's-length transactions should at least raise an "eyebrow" if not a rebuttable presumption as to their possible unfairness. A "show-me" attitude is to be expected in a situation such as you have outlined.

It is futile for us to generalize at this distance on the organizational setup and division of facilities, services, records, etc., necessary to make the subsidiary's corporate identity unassailable. A helpful guide in resolving this point might be some of the opinions in tax cases involving section 482 of the Internal Revenue Code of 1954. The section deals with "Allocation of Income and Deductions Among Taxpayers." Of some general interest also in this connection, may be a Note in the *Harvard Law Review* for April, 1958, entitled "Liability of a Corporation for Acts of a Subsidiary or Affiliate."

DIFFERENCE BETWEEN PARENT'S COST AND UNDERLYING EQUITY IN SUBSIDIARY

Inquiry **496**

Amortization of unallocated excess of parent's cost over underlying equity (or excess of equity over cost)

"*A.R.B. No. 51* (AICPA, 1959) paragraph 8, provides that, where the parent's equity exceeds the parent's cost and the difference is not attributable to specific assets, it is acceptable to show the difference in a credit account and take same into income in future periods on a reasonable and systematic basis.

"However, in paragraph 7, in the reverse situation, where the parent's cost of an investment in a purchased subsidiary exceeds the parent's equity therein, any part of that difference not attributable to specific assets should be shown as a separate asset in the consolidated balance sheet. Nowhere in *A.R.B. No. 51* does there seem to be a provision for taking that debit difference into the income statement in future periods on a reasonable and systematic basis.

"What is the committee's reasoning for amortizing a credit difference but not amortizing a debit difference?"

Our Opinion

While it is true that *Accounting Research Bulletin No. 51, Consolidated Statements* (at par. 7) does not expressly state what the subsequent accounting treatment of an unallocated excess debit should be, it does not follow that the Committee on Accounting Procedure thereby intended to proscribe amortization of the item.

We believe many of the matters discussed in the *Bulletin* stem from surveys undertaken by the Research Department several years ago, one of which appeared in *The Journal of Accountancy* for November, 1953, at pp. 570-6 under the title "Some Problems Regarding Consolidated and Parent Company Statements," the other of which appeared in pamphlet form under the title *Survey of Consolidated Financial Statement Practices* (AICPA, 1956). We guess it can be revealed that the above-mentioned *Journal* survey was directed exclusively to the members of the Institute's Committee on Accounting Procedure at that time. You will note, in the answer to question number one in that survey, the statement, viz.:

> If a reasonable basis for allocating the excess to tangibles or intangibles cannot be determined, such excess should be shown separately *and amortized.* Language such as "excess of cost of investment in subsidiary over book value of stock at date of acquisition" is more appropriate than a general designation such as "goodwill" (*our emphasis*).

We have no knowledge or reason to believe that the committee which issued *A.R.B. No. 51* would reach a different conclusion on amortization of the excess in question than the earlier committee which was informally surveyed — especially since it is now generally accepted that so-called "type (b)" intangibles (see chapter 5, par's 2 and 7, of *A.R.B. No. 43*) which include "goodwill generally" and "organization costs," need not be carried forward indefinitely but may be permissively amortized.

Incidentally, the best explanation of the rationale behind amortization of a credit excess which has come to our attention, is somewhat as follows: In cases where it is impossible or impracticable to allocate the excess to reduce the carrying bases of specific assets of the subsidiary, amortize the excess (which is in the nature of a reserve for general over-valuation) in order to offset the effect of taking costs and expenses (e.g., depreciation or amortization of the subsidiary's assets) into future consolidated income statements at something in excess of either useful cost or actual cost incurred by the parent.

INQUIRY: **496**

Inquiry 497

Consolidation of regulated natural gas companies — reconciling "acquisition adjustment" account requirements and paragraph 7 of Accounting Research Bulletin No. 51

"We have a question concerning the application of "Elimination of Intercompany Investments," paragraph 7 of *Accounting Research Bulletin No. 51* (AICPA, 1959) to regulated natural gas companies.

FACTS

"1. Companies A and B are natural gas companies subject to the jurisdiction of regulatory authorities which require the companies to maintain their books and records in accordance with the *Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act.*

"2. Company A acquired all of the outstanding stock of Company B and recorded the purchase on its books as an investment at cost, and dividends received from Company B are included in Company A's income in the year received.

"3. Company B produces and transmits gas to certain gates for sale to Company A.

"4. Consolidated financial statements are made for Company A and its wholly-owned subsidiary, Company B.

"5. There is an excess of cost of investment by Company A over net assets of subsidiary Company B.

QUESTIONS

"1. Is paragraph 7 applicable to regulated natural gas companies?

"2. If paragraph 7 is applicable, would the amount of the excess of cost of investment over net assets of subsidiary be classified as 'Gas Plant Acquisition Adjustment' in accordance with the *Uniform System of Accounts?* If the classification is proper, what are your comments regarding the requirement of prior approval of applicable regulatory agencies for use of the account?

"3. If the excess of cost of investment over net assets of subsidiary is to be classified as 'Gas Plant Acquisition Adjustments,' then it appears that the amount should be amortized in accordance with the *Uniform System of Accounts.* If the amortization is proper, what are your comments regarding the requirement of prior approval of applicable regulatory agencies for the amortization?

"4. Are any entries necessary on the books of Company A to reclassify the excess of cost of investment over net assets of subsidiary Company B or to record amortization of the excess?"

Our Opinion

In our opinion, par. 7 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* is as applicable *in principle* to regulated natural gas companies as it is to any other type of commercial enterprise. However, it goes without saying, utilities are deemed to be "affected with a public interest," and accordingly, are made subject to accounting and other requirements of a regulatory agency. From a realistic standpoint, then, at least for purposes of financial statements required to be filed with the agency, the utility must adhere to the express accounting requirements of the agency. This would not, of course, preclude the Certified Public Accountant's taking exception in his report to any particular accounting practice required by the regulatory agency and affecting, or reflected in, the financial statements if he feels that such practice does not comport with generally accepted accounting principles.

In perusing *Uniform System of Accounts Prescribed for Natural Gas Companies* (FPC, with amendments effective Jan. 1, 1951) at pp. 16-17 and 39-42, we note that the description of account number "100.5 Gas Plant Acquisition Adjustments" has direct reference to "gas plant acquired as an operating unit or system by purchase . . . or otherwise." No direct reference is made to acquisition of control of an operating property by purchasing the stock of the corporation owning the property. The language "or otherwise" could conceivably cover the situation where stock rather than property is acquired.

Be that as it may, it seems to us that the treatment in consolidated statements filed with FPC, of the excess of the cost of investment over underlying net assets of subsidiary at date of acquisition (assuming the net assets to be carried on an original cost basis), comes within the purview of account number 100.5. However, we feel that in this particular situation, prior opinion of the FPC should be sought as to whether the excess developed in consolidating the statements is properly to be classified as an "acquisition adjustment" and thereafter amortized or whether the excess is to be given a different accounting treatment.

INQUIRY: **497**

You ask for our "comments" regarding the requirement of prior approval of the amortization plan by the agency. We are at a loss to make any comment except to state that since the Commission has the legal authority to approve or direct the disposition of amounts recorded in the acquisition adjustment account, you should seek the Commission's determination. Your report, of course, can state that the statements present in accordance with the accounting rules and regulations prescribed by the agency and may also state any reservations you may have with respect to the statements' compliance with generally accepted accounting principles.

Incidentally, we note that the *Uniform System of Accounts* (at p. 17, 100.5 B.) provides that "Whenever practicable, this account shall be subdivided according to the character of the amounts included herein for each property acquisition." Also, Instruction 2 at p. 40 states that "When practicable, amounts recorded in account 100.5 shall be classified according to the nature of the items of which composed." Assuming the excess of cost of investment over underlying net assets is in the nature of, and is to be accounted for, as Gas Plant Acquisition Adjustments, query whether the above-quoted language would warrant, if practicable, attribution of the excess to specific tangible and intangible assets (essentially as provided by par. 7 of *A.R.B. No. 51*)? The amounts allocable to specific tangible or intangible assets might be indicated to the Commission when seeking the latter's determination as to an appropriate amortization plan.

Regarding the last question raised in your letter, in our opinion, the parent company should continue to carry its investment at cost. No entries should be made on the books of the parent company to reclassify the excess in question or to record the amortization thereof. Such "entries" are essentially consolidated working paper adjustments.

UNAUDITED SUBSIDIARIES

Inquiry 498

Consolidation of subsidiaries unaudited at acquisition dates — audit report considerations

"We are in the process of auditing a consolidated balance sheet of parent and subsidiary companies. The balance sheets of the subsidiaries were not audited as of the dates of acquisition.

"We would like to know whether the necessity for using unaudited book values at dates of acquisition for the subsidiary stock requires a comment, exception, or disclaimer in our audit report letter."

Our Opinion

Since it is a generally accepted accounting principle that assets should be stated at cost when acquired, we believe one of the principal problems with which you should be concerned is the proper recording on the parent's books of the cost of its investments in subsidiaries. If the investment cost is properly measured and recorded initially, it seems to us the subsequent accounting for purposes of preparing the consolidated statements (elimination of investment against underlying net book equity of subsidiary at date of acquisition and appropriate allocation and amortization of any excess) will in any event be reflected in terms of cost to the controlling parent. Your letter does not indicate whether, at date of acquisition, the parent paid cash for the stock of subsidiaries or whether an exchange of the parent's stock for stock of subsidiaries is involved. If cash was paid, no problem in determination of cost exists. If, however, there was an exchange of stock for stock, then the question arises whether the rule governing non-cash transactions might possibly apply, or whether the facts and circumstances indicate a "pooling of interests." In the latter event, it seems to us the auditor would have to express a disclaimer on the combined statements (assuming materiality), since he would have no assurance that the carrying amounts of the net assets of the unaudited subsidiaries carried forward into the combined statements are fairly presented (i.e., represent residual costs properly to be carried forward as a result of the subsidiaries' having consistently maintained their accounts in the past in accordance with generally accepted accounting principles). Subsequent audits of the subsidiaries in some depth *may* provide the auditor with sufficient information and assurance respecting the status of the subsidiaries' accounts at date of acquisition and, currently, to enable him to express an unqualified opinion on the combined statements in subsequent years. In this connection, the following statement from *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957, at p. 24) should be stressed, viz.:

> . . . Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; . . . .

Assuming a purchase of the stock, if the parent's cost is properly set forth in the consolidated balance sheet, any difference between its investment cost and the underlying net assets of the subsidiary should be set up in accordance with par. 7 or 8 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements.* In this connection, see also par. 10, p. 40, of *A.R.B. No. 43.*

We infer from your letter that your audit, presumably of both the parent and the subsidiary companies, is a "First-Audit Engagement." It goes without saying, additional auditing steps and procedures must be undertaken in an *initial* engagement which need not be undertaken in a repeat-audit engagement. The additional first-audit steps and procedures should give you some assurance, or basis for judgment, as to whether post-acquisition transactions have been consistently and properly handled both in the parent's and subsidiaries' accounts.[1] We are assuming that dates of acquisition do not extend back so far in point of time as to make it completely impracticable to attempt to back-track in your audit procedures.

Assuming that you are able to satisfy yourself that there has been a proper accounting treatment for the cost of the parent's investment,

[1] For some helpful discussion, see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 37-43, and in Index therein, see subheading "Initial examination" under such main headings as "Capital Stock," "Inventories," "Property, Plant and Equipment," and "Surplus."

and assuming further that your additional *first-audit* procedures have enabled you to conclude that the post-acquisition transactions have been handled consistently and properly, then we see no reason why your audit report letter should require a comment, qualification, or disclaimer as to the unaudited book value of the subsidiaries at the respective dates of acquisition (purchase).

Inquiry **499**

Audit of management company where investment in unaudited subsidiaries constitutes over 90 per cent of parent's assets

"I have been engaged to audit the books of a management company which administers the operations of two subsidiaries, all of whose stock it owns. One subsidiary is a life insurance company, the other a property insurance company. Each subsidiary pays the management company a supervisory fee based upon a percentage of premiums written.

"The stock of the subsidiaries is shown on the books of the management company at cost and each subsidiary's stock is no-par. I propose to show the stock of subsidiaries at cost on the balance sheet of the management company among investments, indicating the amount for each subsidiary. I also plan to include parenthetically the book value of each subsidiary's stock. The investment in subsidiaries constitutes more than 90 per cent of the assets of the management company. All of these companies were organized about eighteen months ago, and the operations of the insurance companies were begun a few months thereafter. The volume of business has been necessarily low in this beginning period, so that operations from date of organization to date of audit will probably show a loss for all companies.

"Except for an examination of the life insurance company by the State Department of Insurance, no audit has been made of any of these companies. The question on which I should like your comment is this: What audit procedures should be employed in checking on the fairness of the values of subsidiaries' stock as shown on their books?"

INQUIRY: **499**

Our Opinion

We gather from your letter that your audit engagement is confined to examining the accounts and statements of the management company. In view of the fact that the investment in subsidiaries constitutes "more than 90 per cent of the assets of the management company," we believe you would have to disclaim on the management company's statements even if the investments are carried at parent's cost. Without audited statements of the subsidiaries, it seems to us you have no real assurance as to the *extent* of the subsidiaries' initial losses and no reliable basis beyond management's say-so for judging whether there is *permanent impairment* of the investments. In any event, it seems to us the rule of informative disclosure would require a footnote (keyed to the investments carried at cost) indicating that the balance sheet does not purport to reflect investments at current fair value, and that based on unaudited figures, the wholly-owned unconsolidated subsidiaries' losses for the period are X dollars, and that the parent's equity in the unconsolidated subsidiaries has been diminished since date of organization as a result of initial operating or other losses by Y dollars.

It almost goes without saying the fairest presentation here would be achieved by auditing all three companies and preparing consolidated statements, or presenting the separate statements of the operating companies along with the parent's statements. In this connection, see question and answer 5 in the article "Some Problems Regarding Consolidated and Parent Company Statements" which appeared at p. 572 of the November, 1953 issue of *The Journal of Accountancy.*

Regarding your question, "What audit procedures should be employed in checking on the fairness of the values of subsidiaries' stock as shown on their books?": it seems to us you would have to perform complete audits of these subsidiary companies' accounts before you could satisfy yourself as to the fairness of the book values in question. If this eventuates, one reference which may be helpful is *Examination of Texas-Chartered Insurance Company Financial Statements by Independent Certified Public Accountants* (a pamphlet prepared by the Texas Society of CPAs, 26 pp., 2/15/56). This pamphlet discusses certain audit procedures applicable (a) to all insurance companies, (b) to life insurance companies, and (c) to fire, marine, and casualty insurance companies.

MINORITY INTEREST

Inquiry 500

Computing minority interest for consolidated financial statement

"I would appreciate your opinion on the solution of the following accounting problem:

STATEMENT OF FACTS

"A subsidiary of a parent corporation has two classes of stock. *Class A Common Stock* – 2,000 shares are issued and outstanding with a $10 par value. This class of stock has all the voting rights and is owned by the parent corporation. The holder of Class A Common Stock is entitled to receive, as and when declared, a fixed non-cumulative dividend at the annual rate of $.25 per share, and no more.

"*Class B Common Stock* – 1,000 shares are issued and outstanding with a $1 par value. Six hundred shares are owned by the parent company and 400 shares by the minority interest. This class of stock has no voting rights. After a dividend has been paid or set aside for payment to Class A Common Stock for the current year, all other earnings of the corporation belong to the holders of Class B Common Stock and shall be paid to the holders of Class B Common Stock in such amounts and at such times as the board of directors shall fix and determine.

"*In the event of any liquidation or dissolution* – the available funds shall be distributed as follows:

1. To the payment of the par value of the shares of Class A and B Common stock, pro rata and in proportion to the par value thereof.
2. To the payment of the fixed dividend for the current year which shall be due to the Class A Common Stock to the date of distribution.
3. All remaining funds shall be paid to the holders of Class B Common Stock in proportion to their holdings thereof.

"At the end of the subsidiary's first year of operations, it has a net income after taxes of $25,000 which is also the balance of its Earned Surplus account, because no dividend was declared or paid.

"The Capital and Surplus section of the statement at the end of the year is as follows:

Common Stock – Class A		$20,000
Common Stock – Class B		
(Parent Company)	$600	
(Minority Interest)	400	1,000
Total Common Stock		$21,000
Earned Surplus		25,000
Total Net Worth		$46,000

PROBLEM

"What is the value of the minority interest for consolidated statement purposes?

POSSIBLE SOLUTIONS

"Minority interest is valued at:

1. Common Stock		$ 400
Share of Earned Surplus— 40% of $25,000		10,000
		$10,400
2. Common Stock		$ 400
Share of Earned Surplus—		
Earned Surplus	$25,000	
Less: Dividend on Class A Common Stock	500	
40% of	$24,500	9,800
		$10,200

Our Opinion

In our opinion, assuming there is no necessity or occasion here for eliminating any intercompany profit and adjusting the minority interest for any portion thereof, your first solution or computation, namely, $10,400, is correct.

In preparing the consolidated statements, it seems clear that the parent company's investment in Class A common stock at date of organization would be eliminated against the $20,000 of subsidiary Class A common stock outstanding. Assuming the parent paid in the par value on its 600 shares of the subsidiary's Class B common stock, then its $600 investment in such shares would be eliminated in consolidation against the $1,000 of subsidiary Class B stock outstanding, leaving $400 thereof assignable to the minority interest. If thereupon, two-fifths of the $25,000 of earned surplus is deemed further allocable to the minority interest, such conclusion must necessarily be based on the same assumption that generally underlies the computation of "book value of capital stock," namely, the assumption of a *no-gain, no-loss liquidation* at balance-sheet date. If such a liquidation is assumed in this instance, then the minority interest, in addition to the par value of their stock ($400), would be entitled to 40 per cent of the $25,000 of earned surplus ($10,000), the total minority interest therefore being $10,400. No adjustment need be made for a dividend on the Class A common stock since during the first year of operation, no dividend was in fact declared payable to the Class A stockholder. As we construe the provisions of the Class A and Class B common stock contract(s), the Class A stockholder is entitled to a fixed dividend in any year only *as and when* (read "if") declared.

This problem is somewhat confusing since the stock issues in question are "half-breed," i.e., both the Class A and Class B common stocks have some preferred stock as well as common stock characteristics. Incidentally, we believe it is somewhat exaggerated to say that after payment of a fixed dividend on the Class A common, all other earnings of the corporation "belong" to the holders of the Class B common stock. This is true only if an immediate no-gain, no-loss liquidation is assumed *or* if it is assumed that all fixed dividends will be paid out of future years' profits and that future years' losses will not erode the $25,000 of earned surplus. To emphasize the point with an extreme case: the corporation could break even for the next fifty years and pay the fixed dividend each year to the Class A holders, thus using up the entire $25,000 of earned surplus.[1]

Inquiry 501

Consolidated statements — computation of minority interest where subsidiary owns some of parent's stock

"I would appreciate very much, clarification of a matter in connection with the preparation of a consolidated balance sheet for a parent corporation and its partly-owned subsidiary, when the subsidiary is the owner of some of the parent corporation's stock.

"*Accounting Research Bulletin No. 51,* dealing with consolidated financial statements, in paragraph 13 (page 45) states:

> Shares of the parent held by a subsidiary should not be treated as outstanding stock in the consolidated balance sheet.

"The effect of the foregoing is that the parent company's stock held by the subsidiary should be considered as the equivalent of treasury stock. The quoted statement, however, does not specifically cover the matter of determination of the equity of the minority interest in the subsidiary when there have been subsequent profits undistributed.

"For purposes of discussion, the following data may be assumed:

"Company B owns 20 per cent of the capital stock of Company A. The stock is carried at cost. Immediately thereafter, Company A acquired 80 per cent of the capital stock of Company B for $120,000, which was its book value. In the succeeding year, as separate entities, the two companies earned profits as follows:

[1] A workable definition of "minority interest" might be as follows: The portion of the net equity reflected on the books of a subsidiary assignable or attributable to shares (whether voting or non-voting) not owned by the controlling company (or other members of a consolidated group of companies). In allocating the net equity, specified *preferences* (assuming a break-even liquidation at balance-sheet-date book value) must be met. "Full" elimination of intercompany profits and losses in preparing consolidated statements requires pro rata adjustment of the M.I., i.e., of the equity of the "outside" stockholders of the subsidiary which has recorded such profits and losses. But see correspondence *directly following.*

Company A	$40,000
Company B	$10,000

None of this profit had been paid out as dividends, and neither company had unpaid liabilities. The books of the two companies at the end of the year, as of which time a consolidated balance sheet is to be prepared, show the following balances:

	COMPANY A	COMPANY B
Debits		
Sundry assets	$520,000	$100,000
Investment in stock of Company A		60,000
Investment in stock of Company B	120,000	
	$640,000	$160,000
Credits		
Capital stock	$400,000	$100,000
Retained earnings	240,000	60,000
	$640,000	$160,000

"To prepare the consolidated statement (1) the investment of Company A in Company B must be eliminated; (2) the investment of Company B in Company A's stock should be reclassified as the equivalent of treasury stock; and (3) the minority interest in Company B must be segregated.

"Workpaper journal entries for the first two steps are as follows:

(1)

Capital Stock (of Company B)	$80,000	
Retained Earnings (of Company B)	40,000	
Investment in Company B		$120,000
For elimination, based upon book value at date of acquisition.		

(2)

Shares of Company A Held by Subsidiary	$60,000	
Investment in Stock of Company A		$ 60,000
For reclassification of latter, to be shown on consolidated balance sheet as the equivalent of treasury stock.		

"The third step — segregation of the minority interest in Company B — requires determination of the amount of the minority interest. As a minimum, this would be 20 per cent of the capital stock and 20 per cent of the retained earnings of Company B as of the end of the year. Segregation of this amount is made by the following entry:

	(3)		
Capital Stock (of Company B)	$20,000	
Retained Earnings (of Company B).....	12,000	
Minority Interest in Company B		$32,000
For allocation to latter of 20 per cent of recorded proprietary equity as of the year-end.		

"The question arises: Should the minority interest be given an additional credit due to the fact that the profit applicable to Company B's investment in Company A stock has not been taken up by Company B?

"As already noted, the effect of paragraph 13 of *A.R.B. No. 51* is that the stock of Company A held by *Company B* is treasury stock. In this connection, the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, at p. 23.36) states as follows:

> Recognition in full of the parallel between treasury stock and mutual shareholdings implies the following:
>
> 1. Since treasury stock possesses no voting rights or right of participation in dividends, only those shares not mutually held can be considered as representing shares of ownership in the companies involved.
> 2. As a corollary to (1), only to shares not mutually held can there be allocated any share of changes in net worth.

Accordingly, if the classification of the parent company's stock held by the subsidiary as the equivalent of treasury stock means 'recognition in full of the parallel between treasury stock and mutual shareholdings,' the amount allocated to the minority interest by entry 3 is the total of their interest.

"The *Accountants' Handbook,* however, after the statement quoted above relative to recognition in full of the parallel between treasury stock and mutual shareholdings, goes on to say:

> In view of the fact that neither the legislatures nor the courts have yet denied voting rights to mutually held shares, the problem is dealt with as though such shares were on a plane of equality in all respects with those not so held.

and then proceeds with an illustration in which there is assigned to the minority, not only their share of the subsidiary's recorded profits, but also their share of the profits applicable to the parent company's stock held by the subsidiary. Since the profit of each company is dependent upon the profit of the other company, simultaneous equations are used to determine the true profit of each company.

"If the illustration in the *Handbook* were to be followed in connection with the data here under consideration, an additional amount of equity would be assignable to the minority interest in B as shown by the following entry:

Retained Earnings	$2,285.71	
Minority Interest in Company B......		$2,285.71

To allocate to minority, their share of Company A's profit not recorded by Company B, determined as follows:

a = profits of Company A
b = profits of Company B

Then

$$a = \$40{,}000 + .8b$$
$$b = 10{,}000 + .2a$$

And

$$5.0b = \$50{,}000 + a$$
$$-.8b = 40{,}000 - a$$
$$4.2b = 90{,}000$$
$$b = \$21{,}428.57$$

True profit of Company B	$21,428.57
Recorded profit	10,000.00
Unrecorded profit	$11,428.57
Unrecorded profit applicable to minority— 20 per cent of $11,428.57.............	$ 2,285.71

"In the light of all the foregoing, the specific matter on which clarification is needed may be stated as follows:

"1. Should paragraph 13 of *A.R.B. No. 51* be assumed to relate only to display of the parent company's stock held by the subsidiary as treasury stock? If the answer is 'yes,' presumably the calculation of the equity of the minority should take into consideration their share of the unrecorded (on books of subsidiary) profit of the parent company applicable to the shares of the parent company owned by Company B. Or

"2. Should paragraph 13 of *A.R.B. No. 51* be interpreted to mean that stock of the parent company held by the subsidiary is to be considered as treasury stock for all purposes? If the answer is 'yes,' presumably it is not necessary, when the equity of the minority is computed, to allocate to the minority their share of the profit of the parent company applicable to the shares held by the subsidiary."

Our Opinion

We believe that for consolidated financial statement purposes, combined net income, in accordance with the so-called conventional accounting solution described in the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) at pp. 23.36-7, may properly be apportioned as follows:

Consolidated Net Income	
80% of $57,142.86*	$45,714.29
Minority Interest in Company B**	
20% of $21,428.57	4,285.71
	$50,000.00

*$40,000 plus .8b (formula, your letter).
**$21,428.57 equals true profit of Company B (per formula your letter).

For the solution of a reciprocal stockholding situation which we believe is essentially similar to the one outlined in your letter, see pp. 479-83 in Finney and Miller's *Principles of Accounting–Advanced* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1960).

Quite clearly, par. 13 of *A.R.B. No. 51* does not go beyond expressly indicating the manner in which shares of the parent held by a subsidiary are to be displayed in the balance sheet. Although the committee has not explicitly dealt with the question whether the simultaneous equation method should be used in computing the minority interest where a parent's stock held by a subsidiary is displayed as treasury stock in the consolidated balance sheet, it is our understanding the committee gave some consideration to the discussion in the *Accountants' Handbook* at pp. 23.35-40 and was cognizant of the view expressed at the top of p. 23.38 to the effect that treating the mutual holding as treasury shares implies use of a procedure other than the simultaneous equation method in computing the minority interest.

Until this particular matter is clarified by official AICPA pronouncement, it is our personal opinion that either of the methods described in the *Accountants' Handbook* is acceptable.

Inquiry 502

Allocation of earnings attributable to minority interest in determining consolidated net income

"The following covers the salient points respecting our problem on minority interest accounting:

FACTS

"Company P is the parent company and owns approximately 87 per cent of the total outstanding stock of subsidiary Company S. The subsidiary company is capitalized as follows:

	Authorized	Outstanding
Class A capital stock	2,500,000	500,000
Class B capital stock	10,000,000	2,000,000

Of the Class A shares, approximately 350,000 shares are held by the public and constitute the minority interest, while 150,000 shares of Class A stock and all the shares of Class B stock are held by the parent company. Of the total of Class A and Class B shares, approximately 13 per cent is held by the public. Pertinent information regarding dividend rights, conversion, voting rights and liquidation is quoted below.

DIVIDEND RIGHTS

"The holders of the Class A Common Stock and Class B Common Stock shall be entitled to such dividends and distributions as may be declared thereon from time to time by the Board of Directors out of funds legally available therefor, provided, however, in the event of the declaration of dividends in any calendar year, dividends must be paid, or declared and set apart for payment, on the Class A Common Stock in the amount of One Dollar ($1.00) a share, before any dividends may be declared or paid on the Class B Common Stock in such year. After the full preferential dividend on the Class A Common Stock in the amount of One Dollar ($1.00) shall have been paid, or declared and set apart for payment, in any calendar year, the Board of Directors may declare and pay additional dividends for such year, which shall be divided *ratably* among the shares of the Class A Common Stock and the Class B Common Stock, share for share, without distinction as to class. The right of the holders of the Class A Common Stock to the preferential dividend in the amount of One Dollar ($1.00) per share in any calendar year shall be *non-cumulative*, so that the holders of the Class A Common Stock shall be entitled to receive dividends in priority over the holders of the Class B Common Stock only up to a limit of One Dollar ($1.00) a share in any such calendar year. Notwithstanding the foregoing provisions, the Board of Directors may declare and pay dividends in Class A Common Stock upon the Class A Common Stock or dividends in Class B Common Stock upon the Class B Common Stock without reference to the foregoing preferential dividend. No portion of the surplus of Company S is unavailable for dividends on its Class A Common Stock, except to the extent that such surplus must be used to pay dividends on its Class B Common Stock in accordance with the provisions set forth above.

CONVERSION RIGHTS OF CLASS B COMMON STOCK

"Each share of Class B Common Stock is convertible into one share of Class A Common Stock at the option of the holder, commencing in 1964, such conversion privilege exercisable only on February 1 of each such year and subject to the limitation that not more than 200,000 shares of Class B Common Stock may be so converted into Class A Common Stock in any one such year, such number, however, to be cumulative so that, in the event that less than 200,000 shares of Class B Common Stock are converted into Class A Common Stock in any such year, the number of shares of Class B Common Stock entitled to be converted in such year which were not converted shall be carried forward and added to the number of shares of Class B Common Stock which may be converted in the next subsequent year or years. The conversion rights of the Class B Common Stock are protected against dilution in the event of any stock dividend upon or stock split-up of the Class A Common Stock or the Class B Common Stock, or any change of the Class A Common Stock or the Class B Common Stock into a different number of shares of the same or any other class or classes of stock.

Voting Rights

"Each share of Class A Common Stock and Class B Common Stock is entitled to one vote, without distinction as to class.

Liquidation and Other Rights and Matters

"In the event of any voluntary or involuntary liquidation or dissolution of the S Company, any assets available for distribution to its stockholders will be divided among and paid over to the holders of the Class A Common Stock and Class B Common Stock ratably, share for share, without distinction as to class. No holder of any shares of the Class A Common Stock or the Class B Common Stock has any pre-emptive right. All outstanding shares of Class A Common Stock and Class B Common Stock are fully paid and non-assessable.

Statement of the Problem

"In consolidating the parent company and subsidiary company accounts, the question arises as to the amount of earnings which should be allocated above the line net income, to the minority interests. For example, assume subsidiary company earnings of $700,000 per year and dividends of 80¢ per share per year. Translating these rates to dollars, the 13 per cent minority interest results in a reservation of earnings of $91,000, whereas the payment of dividends to the minority interest results in a dividend of $280,000. Basically, the question involved is: Should the minority interest receive an allocation of earnings above the line net income of only 13 per cent or an amount in excess of 13 per cent equal to the amount of dividends paid them?

Approach #1 to the Problem

"The first approach holds that the minority interest is entitled to only 13 per cent of the earnings on the reasoning that this is the maximum right they have in earnings as measured by their legal rights in liquidation. This group reasons that if there were no dividends declared, then the Class A shares would be entitled only to their 13 per cent interest. Also, if 13 per cent of the earnings of S Company should amount to more than the dividends paid, the minority then would still be entitled to their 13 per cent equity in earnings. As to the question of dividends, proponents of this approach feel that dividend actions are wholly independent of considerations of earnings allocations and that there must first be earnings before there can be dividends. In addition, this group would handle the dividends in excess of 13 per cent paid to the minority (the difference between $280,000 paid and $90,000 earnings credited) by a charge in the surplus statement against the majority shareholders' surplus as follows:

Consolidated net income before earnings attributable to minority interests	$1,090,000
Earnings attributable to minority interests	90,000
Net income to earned surplus	1,000,000
Earned surplus at beginning of year	4,000,000
Dividends paid to parent company shareholders	(500,000)
Earned surplus allocated to minority shareholders for dividends	(190,000)
Consolidated earned surplus, end of year	$4,310,000

The thinking here is that the majority, which has the control over the declaration and payment of dividends, by its action in declaring and paying dividends, gives up a portion of its accumulated surplus to the minority. Also, the parent company would follow the practice of bringing the minority interest in surplus and capital on the balance sheet up to a flat 13 per cent at the end of each fiscal year in keeping with the liquidation rights of the minority and majority shareholders.

Approach #2 to the Problem

"The advocates of Approach #2 state simply that *any* diminution of the majority's percentage position must necessarily reflect back against the earnings before such earnings are credited to the respective majority and minority net income. Advocates of Approach #2, in effect, use hindsight by relying upon the dividend actions, which dividend actions necessarily took place after earnings were accumulated, to decide the amount of earnings allocable to the minority interest. With the same set of assumptions as enumerated above, opinion group #2 approaches the problem as follows:

Net income before earnings attributable to minority interests	$1,090,000
Earnings attributable to minority interests	280,000
Net income to earned surplus	810,000
Earned surplus at beginning of year	4,000,000
Dividends paid to parent company shareholders	(500,000)
Consolidated earned surplus, end of year	$4,310,000

"The result of these two approaches is manifested in the line consolidated net income.

	Consolidated Net Income
Approach #1	$1,000,000
Approach #2	810,000
Difference	$ 190,000

"As may be seen, the effect on consolidated net income is substantial, and a definitive opinion stating the correct approach should be obtained forthwith."

Our Opinion

In our opinion, the primary objective in preparing a consolidated income statement is to determine a "final figure" representing the net income of the consolidated group derived from transactions with outsiders which is imputable to the majority or controlling interest in the sense that the latter has exclusive power and right to deal with, dispose of, and apply same for its own valid business purposes. Based on this premise (which we believe to be definitely borne out in practice) as well as other considerations to follow, our personal conclusion is that Approach #1 as outlined in your letter is proper and that Approach #2 as outlined is improper.

We believe the basic fallacy of Approach #2 is that, ex post facto, it recognizes the total current dividend payment to the minority interest as an *income charge or deduction* in arriving at the combined earnings attributable to the majority interest *as if* such dividend payment is on all fours with, say, an interest charge on bonds or a contractual charge on preferred stock *which must be paid in any event*. This latter, of course, is contrary to the facts. Where the declaration-and-payment of dividends, as here, is completely within the discretion of the board of directors of the controlling interest, by every precedent and practice, such dividends are properly to be treated as *appropriations* of current and/or accumulated earnings; in the case in question, Approach #2 deducts the dividends paid prior to arriving at a determination of the very earnings out of which they are appropriated and paid. The subsidiary's "Net Income for the Year" and portion thereof applicable to the parent company's holdings which in turn is properly includible in the consolidated statement of income *as part of* the "consolidated net income applicable to stock of the parent company," is *unaffected* by the fact that the subsidiary's board elects to distribute a dividend to its Class A shareholders which when appropriated from surplus has the effect of disproportionately reducing the residual book equity attributable to the ultimately controlling interest.

In the ordinary situation, i.e., where a subsidiary has only one class of common stock outstanding and the minority interest's share of total combined income is segregated in connection with a consolidated income statement, the allocation is made strictly in accordance with the percentage of the subsidiary's current net income to which said minority interest is entitled in event of liquidation, without regard to whether a dividend is or is not declared and distributed currently. We see no reason why the same principle or procedure should not apply in connection with the Class A and Class B stock in question.

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, at p. 485) contains a discussion somewhat relevant to the problem with which we are here involved. See under the respective headings, "Deduction of Earnings of Subsidiaries Applicable to Minority Interests" and "Deduction of Cumulative Preferred Dividends on Subsidiary Shares." Note especially the first sentence under each heading. One sentence states that "dividends *paid or accumulated* on preferred stocks held by minority interests" should be deducted in arriving at consolidated net income applicable to the stock of the parent company; the other sentence states that provision should be made by a charge against consolidated income *"if a subsidiary* that has cumulative preferred shares outstanding in the hands of the public *does not pay or provide for* preferred dividend requirements." Be this as it may, in the case under discussion, the Class A stock has a preference to a dividend only when, as, and if it is invoked in a given year by the controlling interest. Furthermore, there is no *cumulative* feature attaching to the Class A stock and in every other major respect including voting rights, the Class A stock has common stock features.

In our conversation, you raised the question whether the doctrine that "distributions are deemed to be made first out of the current year's profits, then out of earned surplus, etc.," is relevant in connection with the segregation of a portion of combined income to the minority interest. In our opinion, this doctrine has its origins in tax administration and policy and is neither controlling nor particularly relevant to the question we have been discussing. Perhaps more relevant are the sections appearing in Prentice-Hall, Inc.'s *Corporation Report* service setting forth the statutory base for the payment of dividends in the respective states of incorporation involved. We note that these statutory provisions do not conflict in any respect with the foregoing conclusions, particularly the emphasis we have placed upon dividend distributions as basically appropriations of surplus.[1]

Inquiry **503**

Sale of subsidiary's stock to stockholders of parent company — how reflect "minority interest" (if at all)?

"We would appreciate your help and advice in the recording and presentation of transactions resulting from the sale of part of the stock of a wholly-owned subsidiary.

"The 100 per cent owned subsidiary offers its parent's shareholders common voting stock (the only equity capital outstanding). After acceptance of the offer, the parent owns 85 per cent of the subsidiary. The subsidiary received the proceeds of the sale and credits the net amount received to capital stock and paid-in capital.

"The earnings of the subsidiary have been reported as a part of the consolidated total. The original cost of the subsidiary has been recorded as an investment on the parent's books and in consolidation is eliminated. No entries have been made to the parent's investment in the subsidiary since date of acquisition.

[1] Regarding the "Meaning of 'Consolidated Profit or Loss'" and "Treatment of Minority Interests," see *Consolidated Financial Statements — Principles and Procedures,* by W. H. Childs (Cornell University Press, Ithaca, 1949) at pp. 140-2 and 300-04. As to measurement of the Retained Earnings balance of the Minority Interest, see *Advanced Accounting — Comprehensive Volume,* by Karrenbrock and Simons (South-Western Publishing Co., Cincinnati, 1961) at pp. 519-20.

"Assume:

Original cost of investment	$ 850,000
Subsidiary's shares outstanding prior to offer	850,000
Cost of investment per share – $1.00	
Net amount received from offering of 150,000 shares	650,000
Book value of subsidiary before offering	1,700,000
Per share (on 850,000 shares – $2.00)	
Total book value of subsidiary after offering	2,350,000
Per share (on 1,000,000 shares – $2.35)	
Total book value of subsidiary applicable to:	
Minority interest (15% of 2,350,000)	352,500
Parent (85% of 2,350,000)	1,997,500

"In consolidation at date of sale, there will be an increase in the subsidiary's net worth of $650,000. It appears that 15 per cent of the total of the $650,000 and of the net worth at the date of sale will be shown as minority interest. If so, 85 per cent of the $650,000 less 15 per cent of the net worth at date of sale, i.e., $297,500, will appear as an increase in the consolidated net worth.

"The questions are:

"1. Should the increase in consolidated net worth be shown as consolidated paid-in capital?

"2. Should the increase in consolidated net worth be shown as earned surplus?

a. As an increase during the current year through the income statement:
   i) As a special item
   ii) As a part of the gross income

"How would you show the effect of the following variations from the example given, in the consolidated statements:

a. The *parent* sells 15 per cent of the common stock in a wholly-owned subsidiary to its own stockholders for cash.
b. The *subsidiary* sells more than 50 per cent of its common stock to the public for cash.
c. The *parent* sells more than 50 per cent of the common stock in a wholly-owned subsidiary to the public for cash."

Our Opinion

The net increase of $297,500 in consolidated net worth consists of a credit balance of $425,000 ($500,000 of subsidiary paid-in surplus less $75,000 thereof transferred, when consolidating, to minority interest) which, in our opinion, should be reflected in consolidated paid-in surplus and a debit of $127,500 to the subsidiary's retained earnings account (representing 15 per cent of subsidiary's retained earnings transferred, when consolidating, to minority interest). No portion of this net increase may properly be reflected in the consolidated income statement.

As a possible alternative to setting forth a minority interest of $352,500 in the consolidated balance sheet, we believe it would be desirable if not required in this special situation involving common control (i.e., 85 per cent of the subsidiary's stock is owned by the parent and 15 per cent is owned by the parent's stockholders) to continue to consider the subsidiary as being 100 per cent owned and set up consolidated paid-in surplus in the amount of $650,000. The $650,000 in point of fact represents capital contributed to the consolidated entity by the ultimately controlling interest. In any event, if a minority interest is reflected in the special circumstances of this case, we believe the rule of informative disclosure would require a footnote indicating that the "minority interest" represents the book value of the equity of the parent company's shareholders in the subsidiary's net assets.

It seems to us that where the *parent* sells 15 per cent of the common stock in a wholly-owned subsidiary, say for $650,000 cash, and the sale is to stockholders of the parent, 100 per cent effective control of the subsidiary continues; and if the parent records the sale of 15 per cent of its investment in the usual manner, then $522,500 (the difference between the $650,000 cash received and the $127,500 credit to its investment account, i.e., 15 per cent of $850,000) would be reflected in its income account, a tax of $130,625 applied thereagainst, and the gain net of tax (some $391,875) would eventually lodge in the parent company's retained earnings. Then, upon consolidating the parent and subsidiary statements, if a so-called "minority interest" were set up, it would total $255,000 (15 per cent of $1,700,-000) and furthermore, no consolidated paid-in surplus would be reflected. However, the consolidated retained earnings would be increased by $264,375 ($391,875 gain net of tax on sale of 15 per cent of its investment less $127,500 of the subsidiary's earned surplus assigned to "minority interest").

Under such circumstances, we personally believe the rule of informative disclosure would require a footnote indicating the true nature of the "minority interest," i.e., an interest of the parent company's stockholders in the subsidiary's net assets, and indicating also the fact that $264,375 of the consolidated retained earnings represents a net gain after tax and after allocation of a portion of the subsidiary's surplus to M.I., arising from the parent company's sale to its own shareholders of 15 per cent of its previous 100 per cent investment in the stock of its subsidiary.

If one were asked to draw a moral from the aforementioned circumstances and thereupon formulate a salutary accounting rule that should apply to such a case, we personally believe such a rule should require that the parent's "profit" on sale to its own stockholders of a portion of its investment in subsidiary, *be credited* (*net of tax*) *directly to paid-in surplus,* and that, for purposes of the consolidated statements, no so-called "minority interest" be reflected, rather, that the net amount retained be shown *as consolidated paid-in surplus.* In other words, the consolidated presentation would then be the same as it would have been if the parent's shareholders had merely donated the net amount retained to the parent without the latter transferring to its own shareholders, any of the subsidiary's shares. Our conclusions here, it appears, would be supported by the rule that a corporate group should not reflect a *profit* on transactions in its own capital stock. We are at a loss to know the motivation and circumstances that would impel a parent to sell a portion of its investment to its own shareholders if it meant incurrence of a tax, but perhaps there are such circumstances.

Of course, where the sale of the parent's stock is made to true third parties, then the parent should debit cash, credit its investment account for the carrying value of the stock sold, and debit or credit the difference (if any) to gain or loss on sale of stock of subsidiary. This gain or loss would, of course, be reflected in the consolidated income statement, and the 15 per cent minority interest would be reflected in the consolidated balance sheet.

In the last two situations described in your letter, the usual condition pointing toward consolidation, e.g., ownership of over 50 per cent of the voting shares of another company (i.e., the former subsidiary) is lacking. Accordingly, the parental relationship would be terminated, and the former parent company thenceforth in its statements would merely reflect its remaining investment in the other company (the former subsidiary) at cost.

"COMBINED" STATEMENTS

Inquiry 504

Preparation of combined statements for commonly-controlled enterprises

FIRST INQUIRY

"Recently a client operating as a proprietorship asked me to prepare a consolidated balance sheet for his many enterprises. His proprietorship owns between 90 and 100 per cent of the stock of five or six corporations which have greatly increased in value since his original investment. The stock of these corporations is not readily marketable due to the nature of the businesses (all of which are similar).

"Is it permissible to consolidate corporations and a proprietorship on one balance sheet (1) for credit purposes, (2) inclusion in an audit report, or (3) any other purpose? The client is not receptive to merely showing book value of the corporations in a footnote."

SECOND SIMILAR INQUIRY

"I have a problem to which I am unable to find a satisfactory solution.

"A business is divided into four corporations. One sells, one owns real estate, one owns machinery and one does manufacturing. The stock in each is owned by individuals. There is no intercompany ownership of stock. There are two individuals who own, or control through family relationship, over 50 per cent of the stock of each corporation.

"The selling corporation is attempting to obtain a contract for the sale of about $250,000 worth of manufactured items. The purchaser has asked for a financial statement so that he can ascertain whether the contract can be fulfilled if it is given. The financial statement of the selling corporation alone would show nothing the purchaser wants to know.

"I would like to know the approved method for the presentation of the information required by the purchasing corporation."

Our Opinion

We believe the best way of showing the true state of affairs in a case where several corporations are under the common control of a sole proprietorship, or of individuals, or of some other entity, is by the preparation of what are known as combined statements.

We believe the furnishing of combined statements for affiliated or commonly-controlled but diverse legal and accounting entities is a relatively infrequent occurrence in practice. In *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959), the Committee on Accounting Procedure approves the preparation of combined statements under appropriate circumstances. Paragraphs 22 and 23 of *A.R.B. No. 51* read as follows:

> Combined Statements
>
> 22. To justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation. There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations. Combined statements would also be used to present the financial position and the results of operations of a group of unconsolidated subsidiaries. They might also be used to combine the financial statements of companies under common management.
>
> 23. Where combined statements are prepared for a group of related companies, such as a group of unconsolidated subsidiaries or a group of commonly controlled companies, intercompany transactions and profits or losses should be eliminated, and if there are problems in connection with such matters as minority interests, foreign operations, different fiscal periods, or income taxes, they

should be treated in the same manner as in consolidated statements.[1]

Care should be taken to head up the statements in such a manner that they clearly disclose the units or constituents of the economic entity being reported upon. Although there may be equally good or better titles for a combined statement of financial position, we believe it might well be given a heading such as "Combined Balance Sheet of Business Enterprises under Common Ownership or Control of Mr. ...." (or "of X Company, a sole proprietorship"). A footnote keyed to this title might then state: "This statement includes the assets, liabilities, and net worth of the following: (list the names of the corporations and the sole proprietorship)."

You may also want to consider the desirability of submitting, along with the above-described statement showing only summarized results, a so-called "Combin-*ing* Statement," which we visualize as a columnar statement (or work sheet) showing in separate columns, the assets, liabilities, and net worth of each of the units being combined, together with "eliminations" and "total" columns. In this way, the interunit transactions and eliminations are clearly revealed.

Inquiry **505**

Preparation of combined statements for community chest and related trust fund

"Will you be so kind as to give me the benefit of your opinion as to the alternatives I may have in the presentation of audit reports on two charitable organizations which are related to the extent that I shall indicate below and which have certain transactions between themselves which I shall describe to you. One of them is the Community Chest and the other is what is called the Community Chest Trust Fund created by a Trust Indenture Agreement between the Com-

[1] In this connection, see also question 7, and the answer thereto, in the article "Some Problems Regarding Consolidated and Parent Company Statements" which appeared at p. 570 of the November, 1953 issue of *The Journal of Accountancy*.

munity Chest and certain individuals as Trustees. The Trust was organized in 1953 whereas the Chest has been operating many years.

"The relationship of the two organizations as set out in the Indenture is as follows:

"1. Successors to the original trustees of the Trust have been, under the terms of the Agreement, chosen by the Board of Directors of the Chest.

"2. The trustees of the Trust are described in the Agreement as 'the owners, custodians, and administrators of the funds, assets, and properties embraced within and belonging to the Trust Fund.' However, significant paragraphs in the Indenture read as follows:

> The Board of Trustees of the Trust Fund, annually and in accordance with the provisions herein stated, shall utilize such portion of the income from the Trust Fund, as well as any corpus funds which may be so appropriated as hereinafter provided, for such purposes as will in the discretion of the Community Chest most effectively. . . .
>
> The Board of Trustees shall pay, disburse and deliver such portions of the net income from, or the distributable corpus of, the Trust Fund at such times and in such amounts as shall from time to time be ordered or directed by the Community Chest. . . . Such funds or assets may be paid or delivered directly to the Community Chest, or upon its written direction may be paid or delivered by the Board of Trustees to any person or entity performing the functions of providing the services herein provided, or the Community Chest may direct that such be held by the Trustees for later distribution. . . .
>
> The Community Chest may, from time to time, deliver, assign, or convey to the Board of Trustees money, property or assets which such Board will receive, hold and administer in conformity with written directions and instructions of the Community Chest. . . . Such money, property or assets shall at all times retain a separate identity and upon the written request of the Community Chest so to do, said Board shall promptly return same to the Community Chest.
>
> . . . in the event of termination (of the Agreement), all the properties and assets then constituting the Trust Fund shall vest in the Community Chest. . . .

"Since the creation of the Trust Fund the Chest has delivered to it substantial amounts of cash, securities and other properties and now makes an annual contribution of cash. Through the years the Trust

Fund has been the object of contributions and bequests of cash and properties for various designated purposes and endowments for certain purposes and some undesignated purposes.

"All contributions and transfers made by the Community Chest to the Trust Fund, on the books of the Chest, have been charged off to Surplus, or Fund Balance. Thus, a balance sheet taken from the books of the Chest will not show that it has any interest in the very substantial assets of the Trust Fund.

"The Trust on its books has credited all of the assets received from the Chest to its Surplus, or Fund Balance, account, titled and designated 'Community Chest.'

"The functional distinction between the two organizations is that the Chest is a fund-raising agency, by an annual public campaign, for the purpose of providing supplements to the annual operating budgets of the various charitable agencies of the community, whereas the Trust promotes and accepts privately gifts or bequests in trust primarily to provide funds for capital expenditures of the various agencies supported by the Chest.

"My question is: What kind of audit report can I make on these two organizations? Should it be a consolidated report? Can it be separate reports with explanatory comment in the report of the Chest describing the relationship and the amount of the fund balances (or net worth) of the Trust? Can it be separate reports with comment as to the relationship without mention of the amount? Or, would it be acceptable to submit separate reports with no mention of the Trust Fund and its relationship to the Chest?

"The management of both the Chest and the Trust would like separate reports with no mention or comment as to the relationship. I have no way of knowing what the Directors of the Chest want. It is common public knowledge that the two are closely related."

Our Opinion

Although the so-called Community Chest Trust Fund set up by the Community Chest has all the outward indicia of a valid trust, upon careful examination of the relationship between the two entities, especially when it is noted that the Chest has an unreserved right to control the use or disposition of the money, property or assets in custody of the Trust, it becomes clear that this Trust Fund is merely a custodial, ministerial, or administrative unit of a larger entity.

Obviously, one can prepare statements for a unit (department, branch or division, etc.,) of a larger entity, but whenever such statements are prepared, they should be identified not only by their unit designation, but should also be identified with the larger entity which has direct dominion and control over it. To prepare separate statements for the entities described in your letter without disclosing their relationship or affiliation would, in our opinion, violate the rule of informative disclosure. We make the latter comment only by way of minimum criticism.

Actually, we feel the situation is one which requires the preparation of a combined statement of the financial position of the Community Chest and the Trust Fund. You may want to consider preparing this in the form of a multi-column combin-*ing* statement, either with or without more detailed accompanying separate statements for each unit. This multi-columned statement would present the assets and equities of the two units in separate columns, any adjustments or inter-unit eliminations being made in another column, and a final column setting forth the combined financial position.

In our opinion, to present the financial position of the Chest excluding therefrom the assets of the Trust over which the Chest has complete control involves, at best, the presentation of a half-truth and at worst, a presentation which is misleading.

Inquiry 506

Patents sold or transferred between commonly-controlled corporations

"I am going to be called upon, in the course of an audit, to make a decision with regard to patents sold by a company to another company owned by these same stockholders.

"The situation involved is one in which I have had no previous experience, and one which presents, at least to me, several complexities which will become evident as I relate the problem.

"Company A sold to Company B three patents and their interest in two items for which patents have not yet been issued and, of course, may never be issued. The stockholders in Company A and in Company B are identical with one stockholder owning 80 per cent of both companies.

"Company A sold these patents for $120,000 payable at the rate of $12,000 for ten years. Company A has no cost value in these patents; that is, all development expense has been charged to expense as those costs were incurred.

"Therefore, in our certification of the balance sheets of both companies at April 30, we are confronted with the following problems, and the probable treatment subject to your approval.

"1. The purpose of this sale was to remove from Company A, the larger company, the possibility of being involved in a law suit over these patents whereby it would be conceivable that the company could be liable for a substantial sum of money should these patents be attacked successfully. This is by reason of the fact that they do license these patents to third parties.

"2. We would presume that the patents should appear on the books of Company A as a receivable in the original amount of $120,000 offset by a deferred income account in the same amount. This original entry would be reduced by the actual payment, and in addition $12,000 would be recorded actually as income, and tax-wise would be ordinary income, I presume, because of the relationship of the companies.

"3. The real problem appears in Company B. It would appear that some allocation must be made of the $120,000 as between the remaining years of life in the patents actually issued and the value of the items which presumably may be patented at some future date. Here, I am referring specifically to the actual writeoff by Company B over a specific period of years. In the absence of a definite period of time over which the 'not yet' patented items may be of value, I presume that some reasonable definite period of time could be assigned, which, together with the remaining actual years of life of the patents themselves, would constitute a reasonable period over which all of the items could be of value to Company B.

"I would appreciate your comments on the above-proposed procedure, and any further comments with regard to this matter generally, which you feel would be helpful or necessary to consider in arriving at the decision which will be necessary to properly certify to both companies at our audit date."

INQUIRY: **506**

Our Opinion

In our opinion, the situation outlined in your letter is one calling for preparation of combined statements, either with or without separate individual statements for Company A and Company B. In this connection, *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) indicates in par. 22 that "combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations." The intercompany receivable and payable should, of course, be eliminated on the combined statements. Also, our personal opinion is that the patents and deferred income accounts should be eliminated and any remaining balance which might result from differences in amortization rates applicable to patents and deferred income accounts, should be carried to combined earned surplus.

We question the propriety of carrying the patents as an asset on the combined statements. However, if the patents *nevertheless* are reflected as an asset in the combined statements, we believe the accounting presentation should be the same as it would have been had Company A arbitrarily written up the patents on its own books after it had previously expensed the related development expenditures. Accordingly, if the patents are reflected in the combined statements, a reclassification of the deferred income account would be required, whereby the unamortized balance of development expenditures restored should be credited to earned surplus and the excess of $120,000 over same should be credited to revaluation surplus.

Concerning the paragraph numbered "1" in your letter, we raise the question whether Company A can effectively divest itself of liability for its acts of commission or its omissions which occurred prior to the time of transfer of patents to Company B. We cannot tell from your letter whether such is the case, but if any litigation, possibly or probably unfavorable to your client, is pending or in prospect, counsel's opinion should be sought as to just what the contingent liabilities, if any, might be. We can visualize certain circumstances in which the patents might be wholly or partially worthless. If an attack on the patents is in progress or is in the offing, serious consideration has to be given to the possible outcome to determine whether the patents should have *any* carrying value in the financial statements.

In a situation like this involving common control of two corporations by one stockholder owning 80 per cent of both companies, the basic query remains whether the independent CPA has any responsibility to satisfy himself as to fairness of the "non-bargained" price of the patents inasmuch as an arm's-length relationship between the corporations does not exist. Consideration should be given to whether the $120,000 valuation of patents is supportable on the basis of capitalization of a number of years' royalties from licensees and also whether the $120,000 valuation is supportable on the basis of cumulative patent development costs previously charged to expense.

Regarding the questions raised in the paragraph numbered "3" in your letter, in our opinion, no portion of the total consideration should be assigned to patents-in-process or "potential" patents. If the three patents have different remaining statutory periods to run, and there is no good reason why they should be written off sooner, or even immediately, possibly the $120,000 "cost" to B could be allocated to the respective patents based on some formula related to the royalties they generate from licensees. For another possible approach to the amortization of the total consideration paid or to be paid for the patents, we call your attention to the following statement from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 293):

> ... If several patents are acquired for a lump sum and it is impossible to assign a separate cost to each patent, computation of annual amortization should be based on the group as a unit using an average life which gives consideration to the expiration dates of the principal patents.

MISCELLANEOUS PARENT-SUBSIDIARY AND/OR CONSOLIDATED STATEMENT PROBLEMS

Inquiry 507

Consolidated statements for appliance manufacturer and "lease financing" subsidiary

"We are requesting an opinion regarding the proper accounting treatment of a situation described in the summary which follows.

"A client corporation is considering the acquisition of all the outstanding stock of a company presently owned by the president of our client, but is deferring final action until the accounting treatment of the consolidated statements of the parent and the prospective subsidiary can be resolved. We understand that the auditors of the subsidiary are taking a position different from ours, so your assistance will be very valuable. We believe that the summary gives all the relevant facts.

DESCRIPTION OF OPERATIONS

"Our client, Corporation P, has been manufacturing a household appliance for some years. It costs $350 to produce and sells for $500 wholesale list. Sales are made through a group of carefully selected distributors (D), who buy at the list price and sell to the householder at a fair profit.

"To increase the sales volume, P has encouraged D, when an outright sale cannot be made, to rent the appliance to the householder on a ten-year lease, with monthly payments of the rental. (An option to buy is included in the lease agreement, but based on past experience, this option is rarely exercised.) About half of P's product is marketed under this lease arrangement at the present time.

"However, D does not want to tie up a large amount of capital in rented equipment over such a long period of time, so shortly after P placed its appliance on the market, P's president (and a substantial stockholder) organized S Corporation, in which he is the sole stockholder to help finance the rental transactions.

"Under an agreement entered into between D and S, D may sell to S any appliances which he has rented to his customers, at his cost of $500 per unit. The necessary papers for the transfer of title, etc., are exchanged and D now pays a rental to S for the rented equipment transferred. The rental which D receives from his customer is large enough for him to pay rent to S, maintain service on the equipment, and still make a profit.

"When S buys the equipment he immediately remits to P the list price less a 10 per cent discount allowed by P. In his accounting, S has been entering rental equipment, per unit, $450 (list price $500 less $50 discount) and taking depreciation on this base over a ten-year life.

"P, on receipt of the remittance from S, charges cash with $450 per unit and discount allowed with $50, and credits D's account with $500. D at the same time on notice from S cancels out the account payable to P arising from the purchase of the unit and the account receivable from S for the sale of the unit – both at the $500 price.

"Currently, P is showing a gross profit of $150 per unit on all sales to D which the latter transfers to S, less the $50 discount allowed to S. D has net income from rents received from customers in excess of the maintenance of service on the rented units and the rents paid to S. S has income on rents received from D in excess of depreciation on the units acquired. Note that S does not take the discount allowed by P as income, but applies it as a reduced cost per unit, thus reducing the depreciation base.

"Under the existing conditions, P's president is a substantial stockholder in P and the sole stockholder in S. The D distributors are outside parties. P is our client; S is not. The accounting reflected in the above description has been used for the past several years.

"Now the P owners are considering acquiring the stock of S from the P president, making S a wholly-owned subsidiary. We have pointed out to our client that this transaction involves the consolidation of the accounts for statement purposes and requires the elimination of intercompany profits under *Accounting Research Bulletin No. 51.* To fortify our position, will you give us your comments?"

Our Opinion

In our opinion, where a parent company has a wholly-owned subsidiary, it would be the exception rather than the rule not to prepare consolidated financial statements. Although par. 3 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959) suggests that separate statements may be appropriate when the subsidiary is a bank, or insurance company, or a finance company, and the parent company and possibly other subsidiaries are engaged in manufacturing operations, nevertheless, we personally believe that in the situation described in your letter, the financial position and results of operations would be more fairly presented if consolidated statements are prepared for P and S. Moreover, we believe it is pertinent to inquire whether *combined statements* should have been prepared for Companies P and S from the inception of the latter corporation. In this connection, see par's 22 and 23 of *A.R.B. No. 51.*

At this distance, we find it difficult to discern the business purpose (as contrasted with possible tax purpose) in organizing S to handle the leasing function. Prima facie, it appears that P is selling the "leased" appliances to S for $450 with D acting as a collecting and appliance-servicing agent for S. It appears that D actually purchases

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and resells only about half of P's product, since the other half, as you state, "is marketed under this lease arrangement." *If* the "leasing" transactions are deemed to involve sales and purchases between P and S, then, upon consolidation, intercompany sales and purchases, and intercompany profit would have to be eliminated. Depreciation by S would then be based on cost of the appliances to P.

On the other hand, serious question might be raised here whether the transactions in question are "true-lease" situations at all. If the options to purchase are superfluous due to the fact that the appliances are about ready for the junk heap after ten years of usage, and if the householder by his payments has "built up an equity" in the appliance (see definition of "conditional sale" in *Uniform Conditional Sales Act*), then it may be that, objectively, the so-called "leases" should be construed and accounted for as conditional sales by P. With this interpretation, the $450 payments on "leased" appliances by S to P would probably be viewed as "advances" from S to P.

Inquiry **508**

Consolidation of acquired subsidiaries as of commitment or valuation date rather than closing date

"We have as a client, a corporation whose stock is publicly-owned, being traded in the over-the-counter market. We want to obtain an opinion from you as to what we may do in reflecting consolidated earnings on proposed new acquisitions of wholly-owned subsidiaries.

"As of August 31, 1961, when we prepared certified financial statements for the client, we also prepared certified statements for the proposed acquisitions. The August balances were to be used in arriving at the acquisition costs.

"The attorneys are now (late in December, 1961) closing the transactions, and the client is anxious to report its consolidated earnings for the present quarter to include combined earnings subsequent to August 31, 1961.

"Please advise if we may reflect consolidated earnings for all companies subsequent to August 31, if:

1. The closing agreements indicate that the sale is to have been considered effective as of August 31, or
2. The closing agreement is merely a completed sale at date of closing.

"If we are able to consolidate earnings subsequent to August 31, I would assume that the accumulated earnings at that date would be transferred to capital surplus upon consolidation."

Our Opinion

Although from a technical legal standpoint, it is likely that the completed purchase-and-sale takes place at the closing date and ordinarily such date would be considered the "date of acquisition," nevertheless, we believe as a practical matter you may deem August 31 to represent the date of acquisition, especially since the negotiations between the parties were apparently based on August 31 book values of the acquired companies as certified by your firm. In other words, the commitments of the parties are tied to values as determined at that date. We believe it would be prudent and useful for the parties to stipulate in their closing or other agreement that the transaction is on a *nunc pro tunc* (now for then) basis; i.e., that the closing or consummation of the transaction (now) is deemed to relate back to the August 31 date (then). Earnings of the subsidiaries since the latter date would then be includible in consolidated net income and consolidated earned surplus.

The foregoing assumes not only that proper disclosure of the dates when the several acquisitions are ultimately consummated will be made in the financial statements, but also that the departure for accounting purposes from what may be the legal date of acquisition, will not for any reason which you have not made known to us, jeopardize or foreclose the rights of interested third parties or cause such parties to "change their position" to their detriment.

The foregoing also assumes, of course, that the acquisitions represent bona fide "purchases" (e.g., cash consideration paid for the stock of the several companies) and not "poolings of interests" (stock for stock). See *Accounting Research Bulletin No. 48, Business Combinations*) (AICPA, 1957). If "poolings" are involved, "date of acquisition" loses its technical significance, for in such case, "combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward . . ." (*A.R.B. No. 48*, par. 9) and "statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; . . ." (*A.R.B. No. 48*, par. 12). See also in this connection par. 10 of *A.R.B. No. 48*.

Regarding the statement in the last paragraph of your letter, in our opinion, if consolidated statements are prepared at August 31, accumulated earnings of the acquired subsidiaries at such date should not be reclassified and reflected as capital surplus under any circumstances. Presumably the only time when this question would come up for consideration would be a situation where the subsidiaries' accumulated earnings at acquisition date (or portions thereof) were not eliminated in consolidation because the cost of the parent's investments in subsidiaries is less than the underlying net equity of such subsidiaries at the date of acquisition. In this connection, we cite par. 8 of *Accounting Research Bulletin No. 51, Consolidated Financial Statements* (AICPA, 1959), and invite your attention particularly to the second and last sentences thereof, viz.:

> In general, parallel procedures should be followed in the reverse type of case. Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent's cost. Accordingly, to the extent that the difference, determined as indicated in paragraph 7, is considered to be attributable to specific assets, it should be allocated to them, with corresponding adjustments of the depreciation or amortization. In unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis. A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable.

Inquiry 509

Measuring "cost" or carrying value of investments in subsidiaries and initial capital of newly-organized holding company

"We would appreciate your considered views on the following situation:

"A holding company was formed to acquire the capital stock of several closely-held corporations. They acquired 100 per cent of the capital stock of what we can designate as the 'subsidiaries.' The previous owners of the capital stock of these subsidiaries received in exchange for their stock only common stock in the holding company, which we can designate as the 'parent.' The parent is a Delaware corporation, and it issued 1.5 million shares of Class B common stock with a par value of 10 cents and 4,998 shares of no-par value and no indicated 'stated value' Class A common stock in exchange for 100 per cent of the common stock of the subsidiaries. Also, two shares of the Class A stock were issued to individuals for services; thus a total of $150,000 in par value stock and 5,000 shares of no-par common stock was issued.

"There is no particular value which might be assignable to the subsidiaries, except perhaps their total net worth, which is approximately $100,000, although an appraisal was recently made which indicates that their value (based primarily on indicated earning power) is $5 million dollars. The parent's stock, likewise, has no clearly assignable value, except that a relatively small number of shares have recently been sold by the parent at $3.33 per share in a transaction which could not be properly designated as at 'arm's-length.'

"Management has not itself determined a value to be placed on these subsidiaries for purposes of recording these assets on its books and financial statements, preferring to first consult with us concerning acceptable methods of accounting. The problem, basically, is to determine what method of valuing the stock of these subsidiaries would be most correct, bearing in mind a desired adherence to generally accepted accounting principles and methods, and considering that we will be expected to certify as to the reasonableness of the financial statements in our report. A further consideration is that a registration of the parent with the Securities and Exchange Commission is contemplated in the near future, and thus the financial statement presented must be acceptable to the Commission as well.

"Acceptable accounting treatment of such transactions, in our understanding, indicates that the investment in subsidiaries be recorded at their 'true value,' or at the 'true value' of the parent's stock given in exchange, whichever value would be the most clearly reliable.

"Three alternatives present themselves for consideration. One is that the subsidiaries be valued at an amount equivalent to their book value (net worth) at the date of acquisition, which is approximately $100,000. Assuming that the no-par value capital stock was given a stated value of $1 per share by the Board of Directors, the total amount to be regarded as capital stock would be $155,000. This method would necessarily result in a discount on capital stock, which appears to be illegal under Delaware law, and is for other reasons not a particularly desirable result.

"The second alternative would be to consider that the value of the subsidiaries was equal to the par and stated value of the parent's stock issued in exchange. Again, assuming a stated value of $1 per share for the no-par common, the resulting valuation of the subsidiaries would be $154,998. This would not result in an unacceptable inflation of the value of the subsidiaries as there is evidence that the total value is at least that amount. In addition, the directors of the parent have issued stock with par and stated values equal to this amount. This has, however, been the result of a rather artificial method of evaluation, one might argue, and has been adopted merely for the convenience of making the books 'balance' without indicating that the capital stock has been issued at a discount.

"A third alternative would be to attempt to value the capital stock of the parent, which was given in exchange for the capital stock in the subsidiaries. The appraisal and recent sale of 400 shares at $3.33 (which was based on the appraisal) would result in a total valuation of $5 million dollars. Although this has at least as much theoretical justification as the first two alternatives, it seems to us that the increase over book value, based as it is wholly on assumed earning power, is too great to be acceptable.

"Naturally, whatever method is adopted will be fully disclosed in the body of the financial statement or by footnote. If an acceptable method of valuation can be determined, there would seem to be no reason to withhold an unqualified opinion as to the reasonableness of the financial statement. Indeed, in the light of expected submission to the SEC, an unqualified opinion would appear essential."

Our Opinion

In our opinion, the transaction described in your letter should be interpreted and treated accounting-wise as a "pooling of interests."

The only difference between the transaction described (organization of the holding company and issuance of stock for stock) and a *legal consolidation* is that in your client's case the exchange of stock was not followed by liquidation of the subsidiaries. However, the fact that one or more subsidiaries are kept alive does not prevent a "business combination" from being construed as a "pooling of interests." [See *Accounting Research Bulletin No. 48, Business Combinations* (AICPA, 1957), especially par's 4, and 9 through 11.]

It is also important to stress that since a "pooling" rather than a "purchase" is involved, the question of recording the parent company's investment in the subsidiaries at "true value" is irrelevant, as is likewise the rule governing non-cash transactions. The latter rule—viz.: that where stock (or property) is exchanged for stock (or property), the cost of the property acquired is measured either by its fair value or the fair value of the consideration given up or issued in exchange, whichever is more clearly evident — has its prime application in "purchase" situations.[1]

This having been stated something of a dilemma arises when it comes to recording the parent's investment and issuance of shares, in view of the fact that, prior to giving this matter adequate consideration from the standpoint of coordinating the financial structure of the holding company with what we believe to be the generally accepted accounting requirements — requirements upon which we feel certain the SEC will insist when and if a registration statement is filed — the newly-organized corporation has already issued 5,000 shares of no-par, no-stated value Class A common stock and 1.5 million shares of 10 cents par value Class B common stock (the latter having an aggregate par value of $150,000).

Strictly from the standpoint of accounting for the issued shares of the newly-organized parent corporation, perhaps it is unlikely that such corporation's capital would be deemed "watered" if no stock discount were reflected on its books and said corporation's investment

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[1] The foregoing statements are based strictly on the rationale of *A.R.B. No. 48*, and were made prior to publication of *Accounting Research Study No. 5, A Critical Study of Accounting for Business Combinations*, by A. R. Wyatt (AICPA, 1963). See "Conclusions and Recommendations" at pp. 103-08 thereof.

and capital stock accounts were recorded at, say, $155,000. We say this on the supposition that a case might be made out to the satisfaction of a court or State Commissioner of Corporations that the fair value of the consideration received by the parent company for its issued stock is at least equal to the par or stated value of such issued stock.

However, when combining or consolidating the parent and subsidiaries *in accordance with the "pooling" concept,* upon eliminating the $155,000 investment against the underlying net equity of $100,000, treatment of the $55,000 excess as goodwill would be *precluded,* and accordingly, such excess would have to be reflected as "stock discount" or in any event, as capital impairment.

As you point out in your letter, if the parent records the investment at $100,000, it would also have to record stock discount. Moreover, in combining or consolidating the accounts, the entire underlying equity would be eliminated and, therefore, no earned surplus (if any) could be carried forward.

In the case of a "pooling," one common approach is for the parent company to issue its stock having an aggregate par or stated value not in excess of the par or stated value of the stock of the "acquired" subsidiaries, and to record its investment at an amount equal to the par or stated value of the stock of the subsidiaries. Thus, when combining or consolidating the parent and subsidiaries, the investment would be directly eliminated against the subsidiaries' capital stock, and the earned surpluses, if any, may then be carried forward into the combined statement.

Although obviously we cannot speak for the SEC, nevertheless, our personal belief is that the SEC would not tolerate any amount of writeup of the investment above and beyond the book value of the underlying net equity of the subsidiaries (assuming, of course, that the book value itself is a resultant of the operating companies' having followed generally accepted accounting principles). We also believe the $5 million amount is entirely beyond the realm of possibility as far as generally accepted accounting principles and an SEC filing are concerned.

It seems to us then, that the cleanest approach to this problem would be for the stockholders of the parent company to donate or surrender back sufficient numbers of shares so that the aggregate par or stated value of those remaining issued and outstanding would either (a) equal the underlying net equity of the operating companies, or (b) equal the aggregate par or stated value of the outstanding stock of the operating companies. Such surrendered shares should be restored to the status of authorized but unissued shares. Upon contraction of the presently issued shares, assuming "(a)" above and also that the investment is recorded at the same underlying net equity amount, a zero surplus balance would, of course, result upon combining or consolidating the accounts in accordance with the pooling concept. Assuming "(b)" above and also that the investment is recorded at the aggregate par or stated value of the subsidiaries' stock, then, upon combining or consolidating the accounts in accordance with the pooling concept, earned surplus balances (if any) of the subsidiaries could properly be carried forward.

Inquiry 510

Investment of insurance company in non-insurance subsidiary; treatment in consolidation where investment required to be carried at market

"I should like to request your comments on an accounting problem.

"Our company is an operating life insurance company which prepares its annual statements on the Convention Blank prescribed for life insurance companies and which also prepares a consolidated report for stockholders including the operations of its life subsidiary and a newly-acquired subsidiary which is not an insurance company.

"The Convention Blank specifies that holdings of common stock be valued at December 31 market prices with an exception only for stock of a subsidiary insurance company which may be valued at cost. Our consolidated report to stockholders follows the practice of valuing common stock at market, except for our holdings in a subsidiary insurance company; the latter are eliminated on consolidation.

"Note that our newly-acquired subsidiary must be carried on the Convention Blank at market. Naturally, fluctuations in market value must be included in the results of operations for the year. The Convention Blank provides for such 'unrealized capital gains or losses' to be shown in the surplus statement and our consolidated report to stockholders follows this practice. My question relates to the consolidation elimination for this subsidiary. Naturally, any fluctuations in the market price of our non-insurance affiliate will of necessity be included in 'unrealized capital gains or losses' on the Convention Blank for the parent company.

"Now, how do I eliminate the investment in this affiliate on consolidation? Assume the following figures:

Total consolidated assets	$300,000,000
Consolidated net worth including surplus reserves	130,000,000
Goodwill from consolidation of other subsidiary	–0–
Cost of investment in affiliate acquired late in 1960	3,000,000
Book value of affiliate at acquisition	1,000,000
Market value of affiliate at December 31	2,000,000

"Seemingly, one alternative would be to reverse the $1,000,000 unrealized loss on the affiliate, restoring its carrying value to $3,000,000 as a first step in consolidation. Then, there would be goodwill, arising from consolidation, of $2,000,000.

"However, operating personnel of our company have suggested that the $1,000,000 unrealized loss be allowed to show on the consolidated statement and that goodwill therefore be only $1,000,000. Is this a defensible position?

"What happens if next year the market value of the investment in the affiliate goes to $4,000,000? Following the operating men's proposal, it would then be necessary to increase goodwill to $3,000,000?

"It should be safe to assume in your consideration that the operating company shows no net income of its own in the latter part of 1960 or in the future year. Perhaps, you would want to comment also on the effect on the consolidating entries of such income."

Our Opinion

Montgomery's Auditing (Ronald Press Co., N.Y., 1957, at pp. 290-1, 304, 478-89, and 490-1) and the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, at pp. 23.16-18) state the generally accepted practice with respect to the carrying bases at which investments in subsidiaries are reflected in the balance sheet of a parent company as well as the generally accepted treatment in consolidation of an excess of parent's cost of investment in a purchased subsidiary over the book amount of the underlying net assets thereof.

However, if the regulatory requirement is ironclad that the investment in the common stock of the non-insurance subsidiary or affiliate must be carried at market value, then it is rather fruitless for us to try to advise you strictly in terms of accepted practice. Proper procedure requires allocation, either in consolidation or on the books of the subsidiary itself, of the excess of cost of investment in a subsidiary over the book value of the subsidiary's net assets, as between tangible and intangible assets. Such allocation is precluded, it seems to us, if the investment in the subsidiary must perforce be carried at market.

Under the circumstances we would be inclined to adopt one of two alternative presentations.

One treatment would be to reflect the common stock of the non-insurance subsidiary or affiliate in the consolidated statements as an "investment in unconsolidated subsidiary, at market value" with parenthetical or footnote indication of both the cost of the investment and the parent's equity in the underlying net assets of such subsidiary. Possibly, a case for non-consolidation of the subsidiary in question can be supported on the ground that such subsidiary is not an insurance company as are the other companies in the consolidation.

Another treatment would be to consolidate the non-insurance subsidiary, eliminating the investment at market against the subsidiary's book value at date of acquisition, and reflecting an item designated "Excess of market value of investment in subsidiary over book value of stock at date of acquisition" in the consolidated statements. The latter designation would be a factual description of the excess and more appropriate than a general designation such as "Goodwill." If the market value of the investment were to increase to $4,000,000 in the succeeding year and an entry were made to record or recognize the unrealized gain, then the "excess" would be derived and described in the same manner.

Of course, if the regulatory requirement does not extend to stockholder statements, then we believe you should restore the investment to cost prior to eliminating it in consolidation. It is also our feeling that amortization of the excess should be commenced in preparing consolidated statements.

Incidentally in the Consolidated Report of your company which you enclosed, it appears from the Surplus and Special Surplus Funds statement that when *unrealized* capital gains or losses are recognized, no reduction of the gross amount of the increment or decrement is made for the applicable tax burden or benefit. In line with the tax allocation principle, we believe it would be proper to reflect writeups or writedowns to market net of any taxes which would be applicable upon realization.[1]

Inquiry **511**

Change in parent company's policy — from selling to subsidiaries, to shipping on consignment to subsidiaries; reporting effect on comparability

"We would appreciate your views concerning the accountants' opinion in a short-form report in the situation described in this letter.

"Prior to this year, one of our clients, a publicly-owned manufacturing corporation, sold its products on regular credit terms to a group of wholly-owned sales subsidiaries, which in turn resold the products to unrelated customers.

"During the current fiscal period, the parent company changed from its policy of selling to its subsidiaries on regular credit terms to shipping its products to them on consignment.

"At the end of past fiscal periods, the subsidiaries maintained inventories priced at their cost, which was the selling price of the parent. Since each of the corporations files separate Federal income tax returns, the parent included in its income the intercompany profit in ending inventories owned by the subsidiaries. The parent paid Federal income taxes on this income which was unrealized considering the group of corporations as a whole. Consolidated financial statements prepared for the group gave effect to the elimination of intercompany profits included in beginning and ending inventories.

"The change has the effect of producing the following results:

"1. Federal income taxes of the parent for the current period will be considerably less than if the change had not been made. Net income will be higher to the extent of decreased Federal income taxes.

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[1] On tax allocation generally, see chapter 10B of *Accounting Research Bulletin No. 43* (AICPA, 1953). See also top of p. 500 in *Montgomery's Auditing,* 1957 edition, and pp. 139 and 141, 1949 edition.

"2. The subsidiaries will carry no ending inventories since the parent will own all inventories which will be carried at the parent's cost on its balance sheet at the end of the fiscal period.

"3. Consolidated net income for the group will be higher than it would have been if the change had not been made to the extent of the reduction in the parent's Federal income taxes. Net income reported by each of the subsidiaries will not be affected by the change.

"It is our present feeling that, since the change will affect the comparability of the statements for the period under examination with those of the previous year, the dollar effect upon comparability will be described in a footnote to the financial statements of the parent, the subsidiaries and the consolidated group. We feel that the following addition to the closing sentence of our short-form report will suffice:

> ... in conformity with generally accepted accounting principles, applied on a basis consistent (except for the change indicated in Note ...., which change we approve) with that of the preceding year."

Our Opinion

In our opinion, what is involved here is a change in the legal effect or incidents of the transactions in question, viz., product shipments made to wholly-owned subsidiaries. Whereas formerly the parent effected a sale of its products to subsidiaries upon shipment, under the new arrangement, there is a bailment of its products to its subsidiaries upon shipment. According to generally accepted accounting principles, a profit is usually deemed to be realized by an accounting entity at the time a sale is consummated. It follows that there is no recognition of profit where the transaction takes the form of consignment or bailment (at least until consignee makes a sale to an outsider).

We do not feel there has been any inconsistency in the application of accounting principles as such in the circumstances of this case. Inconsistency in the application of an accounting principle means to us inconsistency in the treatment of identical types of transactions as between fiscal periods. Presumably there is no deterrent to the parent's changing the legal form of the transaction in question. Accordingly, if the change is made in good faith for a valid business purpose and without ulterior motives, then we would conclude that the transactions before and after the change are *non-identical* transactions in *legal* effect, and thus, produce different *accounting* effects.

However, we feel that the company's change in policy regarding shipments to subsidiaries is definitely a material matter which, if not disclosed, would make the statements misleading because of its effect on comparability. We also believe the rule of informative disclosure requires that the dollar effect of the change be indicated.

Since we have concluded that inconsistency in application of accounting principles is not *technically* involved in the circumstances of your case, it follows that we would exclude the parenthetical language that you planned to use in the closing sentence of your short-form report. We call your attention to the discussion of consistency at pp. 51-2 of *Generally Accepted Auditing Standards* (AICPA, 1954). Our view of the changed policy of your client is that it is "the proper consequence of altered conditions." It is essentially similar to a situation where a company which has been selling items of equipment, now decides to lease them. You will note we have construed "altered conditions" broadly to include a change in legal incidents of a transaction. However, you are close to this situation and may feel that item "(c)" on p. 51 of *Generally Accepted Auditing Standards* more nearly describes the change involved. If such is the case, it seems to us that you should then retain your parenthetical language, but eliminate your approval of the change.[1]

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[1] But cf. *Statements on Auditing Procedure No.* 33 (AICPA, 1963) at pp. 42-5, which was published subsequent to the above correspondence. See especially par. 9 which, in discussing "accounting changes required by altered conditions," states that such changes involve "no choice by management." Query whether, in view of this language, a result different from that indicated above would be reached, i.e., from the standpoint of the CPA's explicitly referring to lack of consistency in the opinion paragraph of his report?

Inquiry 512

Adjusting surplus at date of acquisition of subsidiary, to recognize potential tax carryback refund

"Recently, I have encountered a problem regarding the presentation of Federal income tax provision in a consolidated income statement when a newly-acquired, wholly-owned subsidiary has a *potential* refund resulting from a loss carryback at the date of acquisition. I would appreciate obtaining your opinion regarding the questions which follow.

THE SITUATION

"All of the outstanding stock of a manufacturing concern, having a September 30 fiscal year-end, was acquired by another corporate organization on May 31. The parent company's year-end is January 31. A CPA firm has been engaged to perform an examination for the purpose of rendering an unqualified opinion with respect to the consolidated balance sheet and income statements as of July 31 to be used in a registration statement.

"During the first eight months of the current fiscal year (to date of acquisition) the wholly-owned subsidiary (hereinafter referred to as Subsidiary A) suffered losses amounting to $131,000. During the succeeding two months (from date of acquisition to balance-sheet date) the wholly-owned subsidiary had earnings of $80,000. Earnings for the preceding three years amounted to $85,000. The parent company plans to file separate returns for *each* company, rather than filing on a consolidated basis, at the end of the respective fiscal years.

"The parent company also has another subsidiary (hereinafter referred to as Subsidiary B) with earnings of $60,000 at July 31 and a loss carryforward credit of $120,000. The fiscal year-end of Subsidiary B is December 31.

"With respect to Subsidiary A, the amount of income taxes paid in prior years which is refundable as the result of the carryback of losses incurred to May 31 represents an asset at the date of acquisition and enters into the determination of 'surplus at the date of acquisition.' However, it is not possible to determine the amount of the ultimate refund either at May 31 or July 31, since the return will not be filed until the year-end at September 30, and the losses for the eight months ended May 31 will be reduced by profits earned from May 31 to July 31; further, the losses for the eight-month period will also be affected by the results of operations for the period from July 31 to September 30. At best, it appears that any refund asset existing at May 31 is a contingent asset – contingent upon losses existing at the end of the fiscal year.

"The provision for Federal income taxes appearing in the consolidated income statement for the period ended July 31 will be reduced by any loss carryback credit of Subsidiary A and the loss carryforward credit of Subsidiary B. In all instances, assume that amounts are material.

QUESTIONS

"1. Should an estimate be recorded in the accounts at May 31 for the potential refund of Federal income taxes and such estimate be used in computing the surplus at the date of acquisition? If so, how is such an estimate customarily determined – that is, what basis is normally used in arriving at the amount to be recorded? Or, as an alternative to recording an estimated refund, would a footnote disclosing the situation suffice?

"2. What is the customary practice with respect to presentation of the income tax provision in the consolidated statement of income under the aforementioned circumstances: (a) show the reduction resulting from the tax credits parenthetically or in a footnote, or (b) indicate the results of operations without inclusion of such credits and then show the reduction by reason of tax credits as a final item before the amount of net income for the period? In your opinion, which presentation is preferable?"

Our Opinion

We agree with the conclusion or premise stated in the first sentence of the fifth paragraph of your letter. However, if Subsidiary A's surplus at date of acquisition is effectively adjusted, i.e., increased, to take into account the estimated or actual refund due to loss carryback, then we do not believe it would be proper (as stated in the sixth paragraph of your letter) to reduce the provision for Federal income taxes appearing in the consolidated income statement for the period ended July 31 by any loss carryback credit of Subsidiary A.

Our reasons for the latter conclusion are as follows: Assuming an estimate of the potential carryback refund is recorded in Subsidiary

A's accounts at May 31 by a debit to estimated tax refund receivable and an effective credit to Subsidiary A's earned surplus, then upon subsequent consolidation, any excess of the cost of parent's investment over underlying net assets of Subsidiary A at date of acquisition would be less than it otherwise would be (or any excess of underlying net assets over cost would be more than it otherwise would be) by the amount of the estimated refund credited to Subsidiary A's earned surplus. Increasing Subsidiary A's surplus at date of acquisition by the amount of the carryback credit clearly should have the effect of eliminating that amount from consolidated earned surplus. However, to reflect a tax credit due to the carryback in the consolidated income statement would then be undoing the effect of the previous adjustment to Subsidiary A's earned surplus. In our opinion, the $80,000 profit of Subsidiary A for the months of June and July should be included as part of consolidated earned surplus, not the $80,000 profit plus the carryback refund of Subsidiary A.

The only discussion we have encountered in the accounting literature of the specific questions which you raise under "1" in your letter, is the following appearing at pp. 504-05 of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957), viz.:

> When taxable income of a subsidiary is reduced by application of net operating losses incurred prior to acquisition, the proper disposition of the resulting tax reduction may present a problem. Tax recovery may have seemed so assured at the date of acquisition that the amount thereof was included in the assets of the subsidiary at that date; then no problem arises when the reduction is realized. In other instances, while the tax recovery seemed likely, treatment of the recovery in the consolidated financial statements may have been delayed until the recovery is assured.
>
> In the authors' opinion, the preferable treatment is to exclude from consolidated income and earned surplus subsequent to acquisition of the subsidiary any tax benefits arising from losses attributable to periods prior to acquisition of the subsidiary. If the amount involved was not treated as an asset of the subsidiary at the time of acquisition, this exclusion may involve adjustment of whichever account was debited or credited with the difference between cost to the parent company and the amount of net assets shown in the balance sheet of the subsidiary at date of acquisition.
>
> However, if, at the time of acquisition of the subsidiary company, it seemed unlikely that any such subsequent tax benefit would be realized, the authors believe that the tax benefits, when

> realized, may be reflected in income or earned surplus in the year of realization.

In our opinion, although it would be feasible to record the estimated potential refund in Subsidiary A's accounts at May 31, under the circumstances of this case, it would be preferable to set the refund up on the basis of the best estimate possible at the time when the consolidated statements are being made up.

The following passage from *Montgomery* (*op. cit. supra* at pp. 480-1) is also generally relevant to this problem, viz.:

> Subsequent Changes in Net Assets at Acquisition. – Determination of the amounts of assets and liabilities of a company at the date of acquisition of its capital stock by another company involves the same problems encountered in the preparation of a statement of financial position at any date. Passage of time is frequently necessary to determine facts upon which financial position at acquisition date is properly stated. Allowances or provisions for deferred maintenance, for bad debt losses, or for contingent liabilities may be established as at the acquisition date, but such estimates are subject to adjustment when actual liabilities or losses are later determined. Such adjustments relate to the previously determined amounts of assets and liabilities of the subsidiary at date of acquisition, and consequently will be reflected in consolidated financial statements as adjustments of accounts in which the difference, if any, between cost of capital stock and the underlying book amount of net assets is reflected. Any such adjustment of net assets should be definitely related to the position at the acquisition date, and it is customary to adhere rather strictly to the rule of materiality. Unless adjustments are material, they may be reflected in income, and the various accounts at date of acquisition should not be held open for an indefinite period awaiting possible adjustment.

Regarding the question raised under "2" in your letter, we have already stated our opinion that, "under the aforementioned circumstances," no tax credit due to carryback of Subsidiary A's loss should be reflected in the consolidated statement of income. However, in situations where it *is* appropriate to reflect a carryback credit or a tax reduction due to carryforward, the 1957 edition of *Accounting Trends and Techniques* (AICPA, p. 156) indicates that the tax credit was shown as a final or special item in 14 of 16 cases involving carrybacks. The 1958 edition indicates treatment as a special item in 11 of 18 cases. In half of the 18 cases involving carryforward credits, the reduction in taxes was indicated in a footnote. We are personally inclined to favor showing these carryback and carryforward credits as special items.[1]

Inquiry **513**

Long-term notes payable by Canadian subsidiary to U.S. parent — adjustment to recognize devaluation of Canadian dollar

"An Illinois corporation has a wholly-owned Canadian subsidiary which is indebted to the parent company on long-term notes, accrued interest thereon and accrued rents. These obligations are payable to the parent company in U.S. dollars although recorded in the books of the subsidiary in Canadian dollars.

"In view of devaluation of the Canadian dollar in terms of U.S. dollars, the liability for these obligations in terms of Canadian dollars is considerably more than is reflected in the books of the subsidiary.

"Our question is how this additional liability should be treated in the financial statements of the Canadian subsidiary."

Our Opinion

Based on your letter, we assume that the Canadian subsidiary's obligation to the parent company on long-term notes and its liabilities for accrued interest thereon and for accrued rents are pegged in terms of fixed amounts of U.S. dollars.

Responsive to the devaluation of the Canadian dollar, it seems to us the obligations in question should be directly adjusted on the Canadian subsidiary's books to reflect the additional liability, i.e., to

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[1] For a good general discussion (which was published after this exchange of correspondence), see the chapter entitled "Tax Allocation Between Years for Carrybacks and Carryforwards of Operating Losses" which appears at pp. 54-62 of the booklet *Accounting for Income Taxes* (Arthur Andersen & Co., 1961). See also Inquiry 325 herein.

reflect the increased number of Canadian dollars which, when added to the previous Canadian dollar balances of these liability accounts, will purchase the number of U.S. dollars required to be transmitted in payment of such obligations.

It appears that the correlative charges (corresponding to the credit adjustments) may have to be split between asset, current interest and rental expense, and/or earned surplus accounts, depending on circumstances. For example, if depreciable assets originally acquired with the proceeds evidenced by the long-term notes remain on the books, it seems appropriate to adjust such assets in the same amount as the adjustment to the long-term note liability account; with a further transfer from earned surplus to the depreciation allowance account to reflect additional cumulative depreciation on the higher depreciation base. Also, if any portion of the liabilities for accrued interest and rentals pertains to prior periods, it seems to us a corresponding portion of any upward adjustment of such liability accounts may properly be charged to earned surplus.

As general support for the foregoing conclusions, we cite the following relevant passage from chapter 12, "Foreign Operations and Foreign Exchange," appearing at p. 114 of *Accounting Research and Terminology Bulletins* (AICPA, 1961), viz.:

> Long-term liabilities and capital stock stated in foreign currency should not be translated at the closing rate, but at the rates of exchange prevailing when they were originally incurred or issued. This is a general rule, but an exception may exist in respect to long-term debt incurred or capital stock issued in connection with the acquisition of fixed assets, permanent investments, or long-term receivables a short time before a substantial and presumably permanent change in the exchange rate. In such instances it may be appropriate to state the long-term debt or the capital stock at the new rate and proper to deal with the exchange differences as an adjustment of the cost of the assets acquired.

Succinct footnote disclosure of the nature of, and reasons for, the adjustments to the liability and other affected accounts should be made in the financial statements of the Canadian subsidiary.

In our opinion, the suggested procedure restates liabilities from amounts rendered academic by the devaluation to amounts representative of the actual obligation which the Canadian subsidiary is bound to pay.

513 :INQUIRY

Unincorporated Businesses

PARTNERSHIPS

Inquiry 514

Personal borrowings of partners turned over to partnership — partners' loans or partners' capital?

"We would appreciate your assistance in connection with a matter which has come up in the process of preparing a set of financial statements for a new client. We are not preparing statements on which we plan to express an opinion, in view of the fact that our examination will be somewhat limited; however, the statements will be put into a binder with our name on it, together with a covering letter which will disclaim an opinion.

"The client in question is a partnership. The partners have personally obtained a number of loans, the proceeds of which have been turned over to the partnership. On some of these loans, the partnership is making the principal and interest payments, even though the loans are in the name of the individual partners. Our clients desire to show these items as capital. We have taken the position that these items are not capital and, at best, could be treated as partners' loans with an explanation attached that the funds were derived from loans obtained by the partners, and that certain of the loans were being repaid directly by the partnership."

Our Opinion

We are inclined to agree with the position you have taken.

When a partner furnishes money to his firm after its inception, for the regular conduct of its business, such money is not ipso facto regarded as an additional contribution of capital but usually is deemed to be an "advance to partnership property," giving rise to an obligation which is required to be paid ahead of capital. Partners' loans or advances, we believe, generally bear interest; capital contributions generally do not, *except from* the date when repayment of such capital is required.

A distinction may be drawn between "partnership property" or assets and "partnership capital." While partnership property may vary in amount from time to time and may be more or less than partnership capital, the latter as a rule is fixed in amount and cannot be changed except by consent of the firm members.

Have the partners in your case done anything to *formalize* a new amount of partnership capital? Or have they merely expressed their desire *to show* the items in question as capital?

Incidentally, if an item "loans or advances payable to partners" is reflected in the balance sheet, it would then seem to be proper to charge principal payments made by the partnership *for the benefit of* the individual partners, to the loans and advances payable account, and the interest payments to partnership expense. However, if the funds furnished are reflected as "capital," it would then seem to be proper and necessary to charge principal and interest payments made by the partnership, to drawings accounts. If total charges to drawings accounts exceeded the partnership net income or undivided profits, would not the amount represented to be "partnership capital" be impaired as a result?

On the basis of your letter, we have assumed that the partners have in fact borrowed in their personal capacities, that the notes and agreements evidencing the loans, although executed by individual partners, are not on firm paper or in the firm name.

INQUIRY: 514

Incidentally, we think you are to be congratulated on your attitude that disclaimer of an opinion on statements which are nevertheless associated with your name does not relieve the CPA of all responsibility regarding fair presentation. Regarding this matter, see the brief item "Denial of Opinion Does Not Discharge All Responsibility" which appeared in Carman G. Blough's column at pp. 221-2 of the August, 1951 issue of *The Journal of Accountancy;* and see also *Numbered Opinion 8* of the Institute's Committee on Professional Ethics.

Inquiry **515**

Transfer by syndicate promoter, of contract to purchase real estate, to newly-organized limited partnership

"An answer to the following accounting question is requested:

"On a real estate syndication, what valuation should be placed on the fixed assets? The syndication in question was purchased by the syndicator for a certain amount. He then transferred the contract to a limited partnership. The amount which is raised from the public through sale of the limited partnership interests covers not only his expenses in raising the necessary funds but also his profit, if any.

"In addition, the syndicator received a certain amount of subordinated limited partnership interest.

"I am asking this question with particular attention to the New York State law as amended covering such syndications. Said law requires a certified report to be given to each limited partner annually. It is for this reason that the valuation question becomes important. As you note, I am disregarding completely the tax treatment as to cost."

Our Opinion

As we understand the facts, the syndicate promoter and/or manager negotiated a contract to purchase certain property for a specified amount and subsequently assigned such contract to a newly-organized limited partnership in consideration for a limited partnership interest (albeit subordinated) and a partnership obligation to pay him a promoter's or manager's fee as well as reimburse him for costs incidental to securing capital funds.

You ask specifically: What valuation should be placed on the fixed assets? In our opinion, the general rule should apply, viz.: that assets should be stated at "cost" when acquired. The question then becomes one of determining what expenditures made, and obligations assumed by the partnership in connection with acquisition of the property, may properly be deemed to represent the "cost" of the property. Our conclusion is that the ultimate recorded cost of the acquired property may properly include:

1. The total contract purchase price of the property
2. Commissions to real estate agents and costs of examining, insuring, and registering title, including attorneys' fees and any other expenditures for establishing clear title
3. Any portion of the fees or other consideration paid to the syndicate promoter or manager which fairly may be deemed to represent compensation for his "finding" and/or "assembly" of the property, and
4. Costs of improvements, if any, made to the property.

For illustrative purposes, we will assume the following facts:

a. Purchase price of property = $250,000
b. Gross amount of capital (cash) contributed in equal shares by investors A, B, and C = $300,000
c. Total consideration to be paid by partnership to syndicate promoter-manager upon commencing operations = $30,000; of which $10,000 is to be paid in cash, with $20,000 earmarked as his limited partnership capital interest
d. Fair allocation of the $30,000, as follows:
   $10,000 as "Finder's Fee"
   $16,000 as "Cost of Securing Capital"
   $ 4,000 as "Cost of Organizing Limited Partnership"
e. Cash payment for property = $225,000
   Mortgage given or assumed = $25,000
f. Closing costs *et al.* = $10,000

Based on the foregoing, initial journal entries might take the following form:

I. *Dr.* Cash	$300,000	
Cr. A's Capital		$100,000
B's Capital		100,000
C's Capital		$100,000

To record cash capital contributions of investors.

II. *Dr.* Finder's Fee	$ 10,000	
Cost of Securing Capital	16,000	
Cost of Organizing Limited Partnership	4,000	
Cr. Cash		$ 10,000
Syndicate Promoter-Manager's Capital		20,000

To allocate and record consideration paid by partnership to syndicate promoter-manager.

III. *Dr.* Property	$250,000	
Cr. Cash		$225,000
Mortgage Payable		25,000

To record cash payment for property and mortgage obligation concurrently assumed.

IV. *Dr.* Closing Costs *et al.*	$ 10,000	
Cr. Cash		$ 10,000

To record expenditures made in connection with taking title to property.

V. *Dr.* Property	$ 10,000	
Cr. Finder's Fee		$10,000

To capitalize Finder's Fee as part of cost of property.

VI. *Dr.* Property	$ 10,000	
Cr. Closing Costs *et al.*		$ 10,000

To capitalize Closing Costs as part of cost of property.

VII. *Dr.* A's Capital	$5,000	
B's Capital	5,000	
C's Capital	5,000	
Syndicate Promoter-Manager's Capital	1,000	
Cr. Cost of Securing Capital		$ 16,000

To absorb cost of securing capital in proportion to capital contributions.

Entry VII is analogous to the writing off of so-called "stock issue costs," in the case of a corporation, to paid-in surplus arising upon issuance of stock. Of course, the syndication or partnership agreement might expressly provide that the capital accounts of all investors other than the syndicate promoter-manager, be used to absorb the cost of securing capital. The "Cost of Organizing Limited Partnership" might be carried forward indefinitely (the treatment suggested by some authorities for organization costs), or be amortized and charged to operations over an arbitrary period of years.[1]

Inquiry 516

Financial presentation of wife's community interest in partnership, while husband's estate still under administration

"A question has arisen as to the proper presentation on a financial statement of a wife's community interest in a partnership while the husband's estate is under administration.

"We submitted a financial statement to an attorney showing two capital accounts, one for the estate of the deceased and one for the wife of the deceased. Each beginning capital was one-half of the husband's capital as of the date of death. We were informed that the capital account should not have been separate until the period of administration was over and the estate distributed by the court.

"We would appreciate any comment on this point."

Our Opinion

In the absence of specific information on the point, we assume the financial statement in question is a balance sheet of the partnership

[1] For an excellent background reference source on syndications, see "The Why and How of Real Estate Syndications" which appeared in *The Practical Lawyer* for March, 1959, at pp. 49-76. The subject is discussed in six separate articles entitled "Introduction," "Business Aspects," "How the Syndicate Functions," "Tax Aspects," "Syndication Illustrated," and "Regulation Aspects."

perhaps specially prepared to reflect assets and the amount of the decedent's net interest in the partnership at fair value, possibly (1) for inclusion thereof in the decedent's gross estate for estate tax purposes and/or (2) for inclusion thereof in an inventory prepared by or for the administrator for submission to the probate (orphan's, or surrogate's) court.

It appears many questions may arise in connection with the partnership interest of a decedent spouse in a community property state, e.g., — Does the capital or portion thereof contributed to the partnership represent "separate" rather than "community" property? Was some of the property contributed as capital prior to the marriage of the decedent partner? Did the latter contribute property which he had obtained by bequest or devise or as the result of selling real estate acquired in a state not recognizing community property? Are earnings on separate property treated as separate or as community property under the particular state law? Upon liquidation of the partnership, will the indicated amount of the capital interest of the decedent partner actually be realized? In the course of administration, will the decedent partner's interest be substantially diminished by payment of community debts and possibly by payment of separate debts? Has the wife renounced (or will she renounce) her community status for any reason? Does the surviving spouse take the entire community title as under the rule of survivorship pertaining to jointly-owned property? Did the decedent partner leave a will?

Other pertinent questions are: Does any statutory provision or rule of court specifically provide for inclusion of the total community property in an *initial* inventory filed by an executor or administrator? Does the court allow the amount of community property eventually set aside for the surviving spouse to be included in the base used in computing an executor's or administrator's commissions and allowances?

In our opinion, the foregoing indicates that the ramifications of the community property concept involve difficult and complex questions of law. Accordingly, we do not believe the independent accountant should attempt to indicate in part the legal effect of the partner's death by earmarking a portion of partnership capital as the community interest of the wife. We believe a footnote keyed to the decedent partner's capital account stating that such interest, when, as, and if realized upon liquidation, is subject to statutory provisions for the administration of community property upon death of a spouse, would not be inappropriate.[1]

Inquiry 517

A. Treatment of second mortgage held by one partner, upon liquidation of partnership

B. Presentation of mortgage obligation by joint mortgagors

"I hope you can help me with the following:

"1. Two partners built a house, for resale in the regular course of their business. The house is sold, but one holds a second mortgage on that house. Then they decide to liquidate, and they divide the assets all right, until they come to this second mortgage. What is the correct course of action for the accountant?

"2. X Corporation owns an industrial plot. Y Corporation puts up a building on it. The mortgage is written up in both names. Y Corporation can find no buyers for its building, but is liquidating, anyway. How should the mortgage be recorded on the books of X and Y?"

Our Opinion

1. We are not certain we have all the facts. When you state that "one holds a second mortgage" on the house built by the partnership and sold in the regular course of its business, we assume that a purchase money mortgage is *not* involved, but rather, that one of the partners advanced a portion of the purchase price of the house to the purchaser, and *in his personal capacity,* took a second mortgage from the purchaser. If such is the case, we do not see how the mortgage transaction in question affects the liquidation at all.

[1] For a good general reference source respecting community property laws, see "A Short Summary of Community Property Laws," by L. G. Blackstock and J. W. Ledbetter (in *The Practical Lawyer* for October, 1962, at pp. 59-74).

On the other hand, if we assume that the junior mortgage was taken to secure the unpaid portion of the purchase price of the house, and that in taking the mortgage, the partner was *acting for the partnership* and within the scope of his authority, then presumably a mortgage receivable would be reflected in the partnership balance sheet. In such event, the partnership on liquidation might try to assign the mortgage to a bank for its present value. Alternatively, it appears that, upon liquidation, the partnership may assign the mortgage to the partners jointly, their undivided interests therein presumably being based on the profit-and-loss-sharing ratio. Under the terms of the assignment, one of the co-assignees or mortgagees might be given the right to receive payments of principal and interest with the correlative obligation to pay over to the other co-assignee or mortgagee the portion thereof to which the latter is entitled. Another arrangement upon liquidation would be assignment of the entire mortgage to one partner in consideration of the latter's relinquishing a portion of the cash or other assets to which he may otherwise be entitled.

2. Obviously, this question should not be answered categorically on the basis of the limited facts given. Among other matters, it would be helpful to know whether X and Y Corporations are commonly-controlled or dealing with each other at arm's-length, whether there is a lessor-lessee relationship between X and Y, or whether Y was acting solely as independent contractor and promoter for X. You state that "the mortgage is *written up* in both names" and refer to the fact that "Y Corporation can find no buyers for *its* building." (*our emphasis*) It seems to us the legal effect of the transaction or transactions in question must be determined as a basis for properly reflecting such transactions accounting-wise. The question naturally arises whether Y Corporation has anything to mortgage. Does it have a leasehold? Does it own the real property jointly with X Corporation? In addition to the mortgage, did Y Corporation sign a bond or note on which it would be personally liable? Is foreclosure against the property the only legal remedy in case of default on the loan? Under the terms of the loan agreement and the agreement between X and Y Corporations, which corporation is required to make payments of principal and interest on the loan?

Assuming that Y Corporation has no leasehold, that Y Corporation acted solely as independent contractor and promoter for X Corporation, that the construction loan is secured solely by the mortgage

(Corporation X owning the fee to the mortgaged land and thus the improvement thereon), and that Y Corporation signed no instrument making it personally liable on the loan – under such circumstances, we do not believe Y Corporation should record either the asset, i.e., the building *or* any correlative obligation on its books. In our opinion, however, X Corporation should record the cost of the property on its books as well as the mortgage obligation since, according to the foregoing assumptions, X Corporation would be obliged to make payments of principal and interest or otherwise jeopardize its property rights.

On the other hand, if Y Corporation held a leasehold and mortgaged same in connection with construction of the building, then we believe it should record the leasehold improvement on its books at cost as well as the mortgage loan obligation, since it would lose its rights to use and enjoyment of the property unless it made payments on the loan. This assumes a situation where Corporation Y actually intends to exploit its leasehold. In such a case, we do not believe X Corporation need record the improvement as an asset until such time as it reverts. Neither do we believe it should record the mortgage obligation. However, a footnote to the financial statements of X Corporation should present the facts with respect to construction of the improvement and indicate its contingent obligation to make payments on the mortgage loan in the event of default by the lessee.

Assuming finally a situation where Y Corporation, having a leasehold which it has mortgaged, decides to surrender its lease (with or without penalty) and liquidate, then it appears that Corporation X should record the building on its books when it reverts and also set up the mortgage loan obligation.

Inquiry **518**

Purchase of fractional interest in insurance agency partnership

"In an insurance agency (husband and wife partnership) it is intended to permit a salesman, currently on commission, to purchase an interest in the business.

"The formula for setting the purchase price is one and a half times average net premiums over the preceding three years. The maximum amount of interest which can be purchased in any one year is 5 per cent, not to exceed 40 per cent in the aggregate.

"Please advise your opinion as to the correct method of reflecting the purchase of this interest by the salesman."

Our Opinion

1. If at balance-sheet date, the transaction is merely at the "intention" stage, then in our opinion, no disclosure in the statements would be required.

2. If at balance-sheet date, a contract of purchase or contract giving the salesman an option to buy into the business on the indicated basis, has been entered into by the parties, but the option has not been exercised with respect to the year in question, then, in our opinion, disclosure of the salient facts concerning the contract or arrangement is desirable but *not mandatory.*

3. If at balance-sheet date, the salesman has exercised his option to purchase, say, the entire 5 per cent interest applicable to the fiscal year in question pursuant to a contract previously entered into, and if payment has been or is to be made by direct contribution to the partnership, then cash or a receivable as the case requires should be debited, and a capital account in the salesman's name credited, with 5 per cent of the purchase price determined on the basis of the formula.

We believe it would be desirable although *not mandatory* to disclose in a footnote to the statements, both the salient features of the purchase agreement and the fact that the salesman has currently purchased a 5 per cent fractional interest in profits and losses in accordance with the formula and terms established in the agreement. You will note that the foregoing assumes that the 5 per cent "interest" purchased has reference solely to the salesman's profit-and-loss-sharing ratio. If the 5 per cent "interest" purchased embraces or is intended to embrace his *capital ratio* as well as his profit-and-loss-sharing ratio, then, depending on whether the actual amount paid into the partnership and initially credited to the salesman's capital account is more or less than 5 per cent of total partnership capital, it appears that a transfer from or to his capital account and correlative adjustment of the other partners' capital accounts would have to be made in order to reflect the balance of the salesman's capital account at 5 per cent of total partnership capital.

4. If at balance-sheet date, the salesman has exercised his option to purchase a 5 per cent interest applicable to the fiscal year in question, but has made payment directly to the partners rather than to the partnership, then, in our opinion, it would be desirable although *not mandatory* to make the same footnote disclosures as are indicated in the previous paragraph. As far as we are able to determine, there is no rule or principle which would require in the particular circumstances that amounts be transferred from the husband's and wife's capital accounts to the salesman's capital account, unless the "partnership interest" which is the subject matter of the purchase agreement encompasses the capital ratios of the respective partners as well as profit-and-loss-sharing ratios.

5. A not unreasonable conclusion is that in the absence of express provision in the purchase or partnership agreement to the contrary, the "interest in the business" referred to in the agreement would be deemed to refer to the profit-and-loss-sharing ratio only, inasmuch as an insurance agency in which capital is presumably not a material income producing factor, is involved.

Inquiry **519**

Determining partner's share of receivables upon retirement from medical clinic

"A medical clinic that had been established for many years admitted a new partner in 1955. At that time their accounts receivable totaled $57,000. Since 1955, the billings have run remarkably steady (about $90,000 per year). Their collections from 1955 to mid-1960 have run about 88 per cent of billings. Since the clinic is on a cash basis, there have been very few accounts charged off. Thus, the inevitable has happened: The total of accounts receivable has increased from $57,000 to $100,000 because, in essence, the bad accounts have been allowed to accumulate. (Since the billings have been steady, we are not faced with much of a problem in allowing for any 'time lag' between billings and collections.)

"One of the four doctors withdrew in the middle of 1960 and has the idea firmly implanted in his mind that since collections have run at 88 per cent of billings, he is entitled to one-fourth of 88 per cent of $100,000. (We are not concerned here with his right to share in the $57,000 on the books when he entered the partnership in 1955.)

"My problem is this: Can you tell me of any books or periodicals where the effect of failing to write off doubtful accounts is discussed? If this clinic had followed a realistic writeoff policy, the receivables would have remained steady at about $20,000 to $30,000 (once the yearly volume of billings became constant), and this problem would never have arisen. Any leads that you can give me where an authority discusses the fact that steady increases in accounts receivable under these conditions are due primarily to an accumulation of uncollectible accounts would be very much appreciated."

Our Opinion

Unfortunately, there is a dearth of material in the accounting literature discussing the effect of failing to write off doubtful accounts. As the publication *Special Reports — Application of Statement on Auditing Procedure No. 28* (AICPA, 1960) indicates at p. 11:

> Cash basis statements ordinarily do not purport to present either the financial position of an enterprise at a given date or the results of its operation for a given period of time. A statement of assets and liabilities on a cash basis (reflecting, as it frequently does, only assets and liabilities resulting directly from cash transactions and sometimes not even that) is not, except by coincidence an adequate statement of financial position.

It seems to us that if the accrual basis of accounting and reporting had consistently been employed, and if, as you suggest in your letter, the clinic had followed a realistic policy of writing off doubtful or uncollectible accounts, on the basis of an aging schedule and other pertinent information, the dispute about the proper valuation of the accounts receivable would not have arisen.

For whatever value our personal opinion may have, we believe that the clinic should at this time draw up financial statements on the accrual basis at least for the special purpose of evaluating the withdrawing partner's interest in the partnership net assets. It seems to us the gross amount of the open accounts receivable should first be determined. Accounts shown by an aging schedule to be past due for an unreasonable period of time, and accordingly deemed to be uncollectible, should be excluded from the balance sheet. The remaining accounts could then be properly included in the balance sheet, with a reserve of 10-12 per cent deducted therefrom.

Of course, if the withdrawing partner's capital contribution at the time of his admittance to the firm was computed on the assumption that the $57,000 of open accounts at that time was fully realizable, we do think it would be equitable to return any portion of his original capital contribution based on this assumption, which was not in fact realized.

With respect to open accounts other than the original $57,000, which have been excluded from the balance sheet, we believe the continuing partners should assign to the withdrawing partner, all their right, title and interest to specific accounts totaling one-fourth in dollar amount, and then let him assume the burden of trying to collect thereon.

Inquiry **520**

Providing for method of valuing receivables in partnership agreement

"The following deals with a partnership problem.

"Upon the death of one of the two partners, the estate has the right to buy the other partner's interest in the firm. One of the major assets of the firm is its accounts receivable. The partners wish to provide for a method of valuing the receivables in the partnership agreement. They are reluctant to use the past history of collections as a basis, for fear that future economic changes would prove this method ineffective. The receivables are totally unsecured. The business is a retail clothing store located in a relatively unstable area in the south. I submit this problem in the hope that you can recommend an acceptable method of valuation."

Our Opinion

Frankly, we have no magic formula to recommend for the valuation of accounts receivable in the situation outlined in your letter. Hindsight might prove any specific formula inequitable to one of the parties.

However, you may want to consider inclusion of a provision reading somewhat as follows:

> In determining the value of a partner's interest for the purpose of effecting a purchase and sale of such interest between surviving partner and decedent partner's estate, current accounts and bills receivable shall be valued at gross amount billed or billable less reasonable adjustments for prospective returns and allowances and for uncollectible accounts, the latter adjustment to be based on the experienced past relationship during a representative period between bad debts actually charged off and end-of-the-period outstanding accounts receivable, final determination of the estimated net realizable value of the receivables to be made by a Certified Public Accountant mutually acceptable to the parties.

Another possibility (after the introductory portion) might be:

> . . . the latter adjustment to be determined by a Certified Public Accountant mutually acceptable to the parties who shall prepare and base his determination on an aging of the accounts receivable. In making this determination based on the aging schedule, such accountant shall deem all account balances not yet due, and all balances on which any payment has been made between schedule date and the date of his determination, as well as all balances not more than X days past due at schedule date, as 100% collectible; all balances more than X but not more than Y days past due at date of schedule, as 70% (80%?) (90%?) collectible; all balances more than Y but not more than Z days past due, as 50% (60%?) (70%?) collectible; and all balances more than Z days past due, as uncollectible.

Still another possibility would be to provide for a tentative valuation at, say, 90 per cent of the gross value of accounts receivable, with an additional payment or a rebate being made, say, 3 or 6 months thereafter based on the extent to which actual receipts on the accounts in question exceed or are less than the tentative valuation.

The foregoing, of course, are only suggested possibilities which may be adapted. It seems to us the principle and methods of valuation discussed at pp. 11.24-6 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) suggest just about all the alternatives to be used in resolving your question.

Inquiry **521**

Liquidation of partnership — determination of equities as between partners based on capital balances

"I would appreciate an answer to the following question:

"Assume that as a result of operations, drawings, and the disposition of all assets, including cash, and the payment of liabilities to outside creditors, the trial balance on the books of a partnership shows the following balances:

	Dr.	*Cr.*
B, Capital (Debit Balance)	\$4,750	
M, Capital (Credit Balance)		\$4,750

"In this case, B has a 66-2/3 per cent partnership profit and loss arrangement and M has a 33-1/3 per cent arrangement.

"*Queries*: (1) In the above situation, how would the liquidation of these accounts be completed and in what amounts, if any? (2) What authorities can be cited as references?

"There is a matter before an arbitration panel regarding this situation."

Our Opinion

In the situation described in your letter, apparently a portion of the initial capital contribution has been withdrawn by each partner. We are aware that a question might be raised whether interest should be payable to the partnership on withdrawals of initial capital or drawings in excess of profits which have impaired initial capital. Since it appears that there was no provision in the partnership agreement covering this specific point, and since we have perused the *Uniform Partnership Act* (which usually governs in absence of provisions in the partnership agreement as to how a particular matter should be handled) and found no reference therein, one way or the other, as to whether interest must be paid on excess withdrawals, and further, since we have noted the following relevant passages from Holmes and Meier's *Advanced Accounting* (Richard D. Irwin, Inc., Homewood, Ill., 1950, at pp. 288 and 293), viz.:

> In the absence of an agreement a partner is not legally entitled to interest on his invested capital, nor is he to be charged interest on his drawings. . . . When a partner borrows funds from the firm, the effect of the transaction is similar to that of excessive drawings. In general, interest can be charged on the partner's debt if it is so agreed by the borrowing partner and the partnership.

– on the basis of the foregoing, we concluded no adjustments to the partners' capital accounts need be made for an interest factor.

Moreover, we assume that all drawings, operating results, and gains or losses on realization and liquidation have been properly recorded and assigned in accordance with the profit-and-loss-sharing ratio. In this connection, we believe the following excerpt from the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, p. 24.19) is relevant:

> A partnership may be disposed of either by transferring the business as a unit or by the sale (realization) of the specific assets followed by the liquidation of the liabilities and final distribution of the remaining assets (usually cash) to the partners. A basic principle to be observed carefully in all such cases is that losses (or gains) in realization or sale must first be apportioned among the partners in the profit and loss ratio, following which, *if outside liabilities have been completely liquidated or cash reserved for that purpose, payments may be made according to the remaining capital balances of the partners.*" (*our emphasis*)

Since one of the partners has a debit, i.e., negative balance in his capital account, indicating that he has taken out more from the partnership than he initially contributed and/or was subsequently entitled to, whereas the other partner has a credit, i.e., positive balance in his capital account, indicating he still has an equitable claim on partnership assets, which unfortunately are no longer available in the partnership due to the other partner's excessive withdrawals, it seems clear that the overdrawn partner should make a direct contribution in the amount of his debit balance, to the other partner thereby making the latter whole. Stated somewhat differently, there appears to be a practical and equitable basis here for construing and reclassifying the debit balance in B's capital account as a partnership receivable from B which upon realization should be distributed as a liquidating payment to M.

To further document this conclusion, we believe Case 1 at pp. 172-4 of Finney and Miller's *Principles of Accounting – Introductory* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1957) is on all fours with the situation outlined in your letter and should be given considerable, if not controlling, weight in your determination.

Inquiry **522**

Determination of proper balances for partners' capital accounts

"I have some questions concerning a partnership. Actually there are two partnerships and I am a partner in each, and the accounting work is being performed by a national accounting firm.

"Data listed below was furnished by the accounting firm to the attorneys for one of the partners' wives who is seeking a divorce and property settlement.

ACLF Co.
Capital Accounts
as at April 30, 1959

PARTNER	OWNERSHIP PERCENTAGE	PRESENT CAPITAL ACCOUNTS	CAPITAL INDICATED BY PERCENTAGE	OWES PARTNERSHIP	DUE TO PARTNER
C.D.	40%	$107,650.74	$122,554.54	$14,903.80	
G.K.	20%	83,380.29	61,277.27		$22,103.02
P.E.	19%	33,914.28	58,213.40	24,299.12	
J.K.	7%	24,041.90	21,447.04		2,594.86
L.C.	6%	27,492.47	18,383.18		9,109.29
W.R.	4%	16,328.35	12,255.45		4,072.90
R.K.	2%	5,664.16	6,127.73	463.57	
W. T.	2%	7,914.15	6,127.73		1,786.42
TOTALS	100%	$306,386.34	$306,386.34	$39,666.49	$39,666.49

AHDG Co.
Capital Accounts
as at April 30, 1959

PARTNER	OWNERSHIP PERCENTAGE	PRESENT CAPITAL ACCOUNTS	CAPITAL INDICATED BY PERCENTAGES	OWES PARTNERSHIP	DUE TO PARTNER
C.D.	40%	$ 84,730.60	$222,280.46	$137,549.86	
G.K.	20%	144,706.89	111,140.23		$ 33,566.66
P.E.	19%	166,821.51	105,583.22		61,238.29
J.K.	7%	54,147.40	38,899.08		15,248.32
L.C.	6%	43,412.05	33,342.07		10,069.98
W.R.	4%	30,941.35	22,228.04		8,713.31
R.K.	2%	17,470.67	11,114.02		6,356.65
W. T.	2%	13,470.67	11,114.02		2,356.65
TOTALS	100%	$555,701.14	$555,701.14	$137,549.86	$137,549.86

"I think it is obvious from the above computations that the correct method would be to eliminate capital account of Partner C.D. and to divide the remaining capital balance by 60 per cent to arrive at the proper amount of shortage owed by Partner C.D. to the partnerships.

"Will you advise me of your opinion concerning the correct computation to be used?"

Our Opinion

Holmes and Meier's *Advanced Accounting* (Richard D. Irwin, Inc., Homewood, Ill., 1950) indicates at p. 282 *et seq.* that

> The principal matters on which the (partnership) agreement should contain precise provisions are as follows: . . .
>
> 4. The capital to be contributed by each partner; . . . .
> 9. The nature and extent of the drawings to be allowed each partner, and whether or not interest is to be charged on drawings.
> 10. The treatment of capital contributions in excess of agreed amounts; the treatment of loans by partners; interest, if any, to be allowed on the capital of the partners.
> 11. The treatment of the excess of profits over allowed drawings or the excess of allowed drawings over profits. . . .
> 17. The manner in which disputed questions may be settled.

In addition to the above, we believe the following paragraphs at pp. 283-4 and p. 288 (*op. cit.*) should be noted:

> In general, two proprietorship accounts are necessary for each partner. A Capital account is required to record the original investment and any additional permanent investments or withdrawals. A Drawing or Personal account serves to record the current drawings and the distribution of the proportionate share of the profit or loss during a current period. The Drawing account should be ruled and balanced at the end of each fiscal period in order to compare the amount of drawings during the period with the partner's share of profit or loss for the period. If there was no balance in the Personal account at the beginning of the period, a credit balance indicates that drawings were less than the share of profits for the current period, and a debit balance indicates that drawings exceeded the share of profits for the period. The disposition of the year-end balance in a Drawing account depends upon the partnership agreement. If the balance is to be considered as a change in the partner's permanent capital investment, the balance in the Drawing account should be closed to the Capital account. If it is agreed that the balance does not change the amount of the partner's permanent capital investment, then the Drawing account should be left open. However, the mere transfer to the Capital account of profits left in the business does not of itself increase the partnership capital or prevent the retained profits from being drawn by the partner at a later date. In some cases, retained profits are credited to a separate partner's Retained Profits account.
>
> Interest on Capital Contributed. – In the absence of an agreement a partner is not legally entitled to interest on his invested capital, nor is he to be charged interest on his drawings. When partners contribute different amounts of capital, they may agree that a certain amount of the profits should be divided in the ratio of the permanent capital. To achieve this result, interest at an agreed rate may be computed on the capital investments and credited to the partners' Personal accounts; the debits are a distribution of the profits.
>
> When the partners agree that withdrawals are reductions of the capital investment, they may provide that interest be charged on the withdrawals as well as credited on the capital invested. This procedure amounts to a computation of interest on the average capital invested, and the net Interest debit is a distribution of the profits.

Lavine's *Modern Business Law* (Prentice-Hall, Inc., New York, 1954, at p. 471) points out that

> ...Partnership capital is fixed in amount and cannot be changed except by consent of the firm. Partnership property may vary in amount from time to time, and may be more or less than partnership capital. . . . Partnership capital does not necessarily include undivided profits, although the partnership agreement may provide that individual profits will, at the option of the partners, become part of the capital.

We have no way of knowing, from the information supplied us in your letter, whether any partnership agreement exists, either for ACLF Company or for AHDG Company, containing provisions to be followed or provisions which are relevant in resolving a situation such as that outlined in your letter.

Should there be such a partnership agreement in existence, then, it seems to us, a decision as to whether either or neither of the two methods of computation described in your letter is the correct computation to be used, should be made in the light of any relevant provisions of the agreement. If no articles of partnership exist to which reference can be made for a solution of your problem, or if they are silent in this regard, then we believe you may want to consider the following suggestions which we offer as alternative, but not exclusive, modes of settlement, bearing in mind, however, that it now becomes a matter of what arrangement the parties are willing to agree to, and not a matter of which method is *the* correct solution.

1. Determine the initial capital contributions made by the partners and derive respective ownership percentages based thereon. Then those partners whose capital accounts now stand below their initial investments should make additional capital contributions to bring their capital accounts up to the original figures, and those partners whose capital accounts are greater in amount than their original capital contributions should either treat the excess amounts as advances or loans to the partnership, transferring these excess amounts to an appropriately designated account, or withdraw them from the business.

2. As the *Accountants' Handbook* (R. Wixon, ed., Ronald Press Co., N.Y., 1956) points out at p. 24.16, circumstances may arise when it becomes desirable to adjust the partners' capital account balances to certain ratios, most often the profit and loss ratio, even when no change in personnel has occurred. Thus, *if* the partners can agree in the present situation *that the total of the present book balances in their capital accounts now constitutes the total capital* of the business,

then we believe the computations or data contained in your letter would implement such agreement or premise and would be essentially similar to the illustration in the *Handbook.*

3. On the other hand, *if* the partners can reach an agreement to the effect *that the sum of the present book balances in all the partners' capital accounts, except that of C.D., is to constitute 60 per cent of the total capital investment* (this, of course, is the *premise* of the method indicated by you as being "obviously correct" in the next to the last paragraph of your letter) then, based on such agreement, there would be no grounds for questioning the method which you favor. Absent an agreement that would support the premise underlying your method, there is nothing "in the nature of things" as far as we know that necessarily supports such method.

4. Where the articles of partnership are silent, or non-existent, the partners, after due consideration of the needs of the business, and the equities involved, may agree that the total capital of the company is to be more or less than (1) initial total capital, or (2) the total of present book balances of capital accounts, or (3) total capital as derived by your proposed method of computation. If such be the case, it goes without saying appropriate adjustments would have to be made where necessary so that each capital account will be stated at its proper ownership percentage of the newly-agreed-upon total capital.

The nub of what we have stated above is that in the absence of actual agreement or a clear rule of law which points the way to a resolution of the problem, each method of computation has its own premise as to what total capital is, or should be, and in our opinion, no single computational method has "right" exclusively on its side.

Inquiry **523**

Determination of book value of deceased partner's interest by "usual accounting practices"

"I represent a client involved in litigation wherein the existing partnership agreement provided that a surviving partner may purchase the interest of the deceased partner for a sum to be arrived at by 'the then accountant for said partnership who shall forthwith establish the book value of said deceased partner's share by the use of usual accounting practices.'

"The assets of the partnership consisted of real estate and stocks, and there is a substantial difference between the valuation as established by book value as compared to true or market value.

"I am wondering whether the Institute has published anything dealing with the responsibility of accountants in preparing a valuation of a business on death of a partner, or can you refer me to any other relevant source material?"

Our Opinion

None of the AICPA's bulletins or publications have ever dealt with the "responsibility of accountants in preparing a valuation of a business on death of a partner." However, we believe you will be interested in the discussion and definition of the meaning of the term "book value" in the AICPA's *Accounting Terminology Bulletins No. 3, Book Value* (1956), and particularly in the Stans and Goedert article, "What Is Book Value?", which appeared in *The Journal of Accountancy* for January, 1955, at pp. 38-46.

In a situation such as the one you describe, accounting literature does not make it clear whether the accountant should adhere to preparation of statements in accordance with principles and concepts regularly used in situations where the enterprise is a going concern, or whether he should prepare statements which would give effect to current fair values on the ground that he is faced with a "Special-Report" situation, i.e., one in which statements are being prepared for a special purpose.

On the basis of the language of the agreement which you quote in the first paragraph of your letter, it would not be unreasonable to conclude that the parties contemplated preparation of statements in the same manner as they always had been prepared in the past.

On the other hand, there is at least a question whether the parties, in using the term "usual accounting practices" intended or deemed it to embrace (rightly or wrongly) valuation or appraisal procedures. It does not appear that the parties using this language were aware of the following passage from the AICPA's *Codification of Statements on Auditing Procedure* (1962, at p. 13),* viz.:

> In no sense is the independent certified public accountant an insurer or guarantor, nor do his training and experience qualify him to act as a general appraiser, valuer, or expert in materials.[1]

SOLE PROPRIETORSHIPS (Financial Presentation Aspects and Auditor's Opinion)

Inquiry 524

May an opinion be expressed on proprietorship (and partnership) statements?

"Within our organization we have had quite a discussion as to whether or not opinion certificates, qualified or non-qualified, should be issued with respect to individual sole proprietorship or partnership-type entities.

"There are two trends of thought: one is that the opinion applies to the business only, while the second thought is that the opinion applies to the individual or to the partners, in the case of a partnership, as well as to the business being reviewed.

"If the first thought is correct, we see no reason why a certificate cannot be given, whereas if the second thought is correct, then perhaps a certificate should not be given. The problem seems to be one

* Cf. *S.A.P. No.* 33 (AICPA, 1963) par. 8, at p. 12.

[1] Two additional references which we believe may be of particular interest in connection with this problem are:

1. *Tax Values of Business Interests — Close Corporation Stock, Partnerships, Sole Proprietorships* (copyright Kennedy Sinclaire, Inc., published for Trust Dept., The American National Bank, St. Paul, Minn., 1960).
2. *Organizing Corporate and Other Business Enterprises,* by C. Rohrlich (Matthew Bender & Co., N.Y., 1958). See sections 4.22 through 4.26 therein, especially section 4.23 which discusses several bases for "Fixation of Price" in buy-sell agreements.

of drawing a line as to just where the responsibility for a certificate ends. Does it end with the particular business, or is it implied that the opinion refers to the individuals as well?

"We would appreciate your thoughts as well as any information you might be able to send us regarding this matter."

Our Opinion

Unless explicitly stated otherwise, we believe it is generally accepted in the profession that the CPA's opinion applies or should be confined to the business operations of the proprietorship or the partnership, as the case may be, and does not embrace the personal affairs extraneous to such business operations, of the sole proprietor or the individual partners. However, especially in the case of the sole proprietorship, the inherent difficulty of clearly delineating the accounting entity and maintaining an accurate segregation of "business" and "personal" transactions, is notorious.

You will be interested in the following news item which appeared at page 12 of the November, 1952 issue of *The CPA*:

> An opinion can be expressed on proprietorship financial statements relating to a business entity provided possible and appropriate limitations are brought out in the financial statements or in the accountant's report, according to AIA committee on audit procedure.
>
> The committee arrived at this decision following a request from the committee on accounting procedure, which was in doubt as to whether such an opinion could properly be expressed. The question was raised because of the close relationship between the personal and the business assets and liabilities of proprietors.

In connection with the question you raise, the following considerations may deserve reiteration:

1. Since business assets are available for the settlement of any personal liabilities which proprietors may have, the question of whether a proprietor has large personal obligations or judgments outstanding against him which must be satisfied out of his business assets becomes a crucial consideration in expressing an opinion on the financial statements of the proprietorship business entity.

2. There is also the possibility in these cases that assets have been taken up on the books of the business but that no corresponding or correlative liability has been reflected in the accounts, such liability being looked upon as a "personal" obligation.

3. Another problem may arise if the accounts or other records of the proprietorship or partnership include personal items as well as business items, or if transactions arising out of business activities other than those presumably being reported upon, are included in the same accounts.

4. Any entity subject to audit examination must meet the test of being "auditable." Many proprietorships do not meet this test. The business or accounting entity must be one which can be rather clearly defined so that assets, liabilities, and transactions may readily be associated therewith and statements properly identified. It should also be stressed that there must be adequate records, procedures, and personnel in existence. If records are seriously inadequate, if supporting data are not available, or if the accounting operation is carried out without an understanding of its objectives, the examination becomes an investigation and probably a bookkeeping job rather than an audit.

For whatever value they may have, several examples which have come to our attention of language used by accountants in connection with proprietorship statements and reports follow:

> a. The balance sheet of the Proprietorship includes only the assets and liabilities of the proprietor which relate to the business operating under the name .... No provision has been made in the balance sheet for the proprietor's liability for federal taxes on income derived from the operations of the business, and the extent to which assets of the proprietorship may be used to pay this income tax liability has not been determined.
>
> b. Comment covering a Scope of Engagement for a single proprietor for whom the accountant also prepares tax returns which include income from sources audited by other accountants:
>
> Our engagement consisted of the verification of assets and liabilities as at ...., together with a test-check of income and expense items for the .... months then ended, of the single proprietorship conducted under the trade name "..... ......" Other business transactions of the proprietor, if any, not reflected in the books and records presented to us, were not examined and are not reflected in this report. We used the analyses prepared in

connection with the audit as the basis for revising the accounting system. The revision was completed, and the revised system was placed in use effective ....

c. Each financial statement is headed and the opening sentence of the report gives the trade name followed by "(A. B. Smith, Sole Proprietor)." Just before the opinion, this paragraph is inserted:

The accompanying balance sheet and statement of income reflect only those assets, liabilities, and operations of A. B. Smith which relate to the business operated by him under the name of The Smith Company, and which are disclosed by the accounting records of that business.

d. All liabilities relating to your business transactions appear to be stated with essential completeness so far as it has been practical for us to ascertain from your accounts. It is not intended that your accounts or the statements presented should exhibit liabilities, if any, concerned with your personal affairs.

e. The accompanying statements of the Proprietorship are based solely on such books, records, and other underlying data as were made available to us. No audit has been made of other personal affairs of the proprietor.[1]

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[1] These examples were suggested prior to publication of the booklet *Special Reports — Application of Statement on Auditing Procedure No. 28* (AICPA, 1960). See the discussion therein at pp. 17-25.

The following items which appeared in Carman G. Blough's column in indicated issues of *The Journal of Accountancy*, should prove helpful:

1. "Treatment of Partners' Loans in Balance Sheet" (Feb., 1949, p. 157).
2. "How to Present Interest in Partnership in Balance Sheet of an Individual" (June, 1949, pp. 497-8).
3. "Reports on Proprietorship" (June, 1950, p. 532).
4. "What Is Adequate Disclosure of Personal Assets, Liabilities, of Proprietors, etc.?" (Oct., 1950, p. 353).
5. "Should Personal Obligation of Partner Be Disclosed in Partnership Balance Sheet?" (Jan., 1954, pp. 82-4).
6. "Is a Proprietor's 'Salary' Cost?" (Aug., 1955, pp. 76-7).
7. "Presentation of Partners' Equity" (April, 1956, p. 64).
8. "Disclosure of Partners' Personal Obligations" (Jan., 1957, p. 52).
9. "Financial Statements of Unincorporated Businesses" (Jan., 1962, pp. 70-1). Reprint of Bulletin No. 19 of Committee on Accounting and Auditing Research of Canadian Institute of Chartered Accountants, which appeared also at pp. 170-3 of Aug., 1961 issue of *The Canadian Chartered Accountant*.

See also the item, "Can You Give an Unqualified Opinion on a Proprietorship?", by W. R. Flack (in *The Journal of Accountancy* for May, 1954, at p. 603).

Inquiry 525

Should personal loans obtained by sole proprietor be reflected as notes payable on proprietorship statement?

"A client of mine operating a publishing company as a sole proprietor asked me to prepare a financial statement. My client has an application pending with a leasing corporation for additional funds, and this statement was requested by the leasing company.

"My question is: Since he is a sole proprietor and the statement is supposed to cover the business assets and liabilities only, am I to show on his financial statement liabilities in form of notes which are payable to close relatives, such as his mother and others? These loans were made quite some time ago, and I do not know what the purpose of these loans was. These loans are not carried on the books of account; however, by analyzing the proprietor's withdrawal account I noticed the interest payments, and upon questioning my client, he stated that he had several personal loans with relatives.

"He also recently obtained a loan from a savings and loan association by pledging his personal residence. The proceeds of this loan were deposited in his business account and shown as an additional proprietor's investment.

"I would like to know whether the above liabilities should be shown on the financial statement. If not, should any disclosure of these existing liabilities be made, and in what form?

"How much investigation should be made to determine the exact amount and type of liabilities he may personally have which are not reflected on the books of account? My client stated these are personal obligations which should not be reflected on the books of account. None of the obligations are secured by any business property. They are merely promissory notes executed by him and the loan from the savings and loan association, as stated, is secured by his residence.

"Your help in clarifying this matter for me will be appreciated since a number of my clients are proprietorships or partnerships, and problems of this nature are constantly presenting themselves."

Our Opinion

We believe some accountants would subscribe to the view that if funds borrowed in a personal capacity are utilized in carrying on proprietorship business operations, such funds when and to the extent contributed to the proprietorship should be reflected as a loan obligation, whether or not the loan is secured by other business assets, so as to indicate the primary or ultimate sources of proprietorship capital. Possibly other accountants would take a more restricted position to the effect that specific loan obligations should be reflected on the balance sheet of the proprietorship only if secured by specific proprietorship assets. However, we know of no authoritative literature on this subject which would require either of the above treatments.

Our own particular view of the matter is that personal loan obligations should not be reflected in the balance sheet even though the funds are utilized in proprietorship operations. It goes without saying if any proprietorship assets are known to be pledged or encumbered, disclosure of such fact should be made. However, in our opinion, "necessary explanation" should be made in a footnote to the balance sheet or otherwise in the accountant's report to the following effect, viz.:

> The estimated liability for taxes applicable to proprietorship net income has not been provided for in the financial statements inasmuch as the sole proprietor files his return and pays his taxes on several sources of personal income in his individual capacity. Moreover, all funds advanced or contributed by the proprietor and utilized in proprietorship operations, are reflected in the balance sheet as capital investment, irrespective of the source of such funds. No determination has been made whether any portion of such funds represents the proceeds of personal loans.

We believe the foregoing language would properly delimit the CPA's responsibility in the circumstances, and put a credit grantor or other reader of the proprietorship financial statements on notice that he should assume the burden of making any further inquiries as to personal financial transactions and involvements of the proprietor.[1]

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[1] For a *contrasting* opinion, see the item (Inquiry 514) in this chapter entitled "Personal Borrowings of Partners Turned Over to Partnership — Partners' Loans or Partners' Capital?"

Inquiry **526**

Should personal residence and mortgage indebtedness thereon be reflected in balance sheet of sole proprietorship?

"I have the following questions to which I would appreciate having your answers:

"In preparing balance sheets for individual owners of small businesses, should their personal residences, and the mortgage indebtedness thereon, be shown? Quite often, such equities are substantial. Frequently, monthly mortgage payments are so material as to affect their ability to handle additional (business) obligations. If they are to be included, how may they best be shown? Would it be proper to show only the net equity, by deducting the indebtedness from the cost, under other assets or should the residence and its mortgage be shown separately, under other assets and other liabilities, respectively? If the liability is shown separately, should the next year's scheduled principal reduction be broken out and separately classified as a current liability? I realize this is a rather comprehensive question, but it is one that I believe is faced almost daily by CPAs with smaller clients."

Our Opinion

In our opinion, neither a personal residence together with mortgage obligation thereon nor any other personal assets and liabilities not strictly attributable to business operations, should be reflected in a balance sheet prepared for a proprietorship. Admittedly, it is often difficult to delineate the accounting entity in the case of some proprietorships, i.e., to know precisely where to draw the line between personal and business transactions or personal and business assets and liabilities. We have in mind particularly those instances in which assets may be jointly used, i.e., used personally part of the time, in the business the rest of the time; or instances where transactions arising out of business activities other than those presumably being reported upon, are included in the same accounts; or instances where liabilities relating to the proprietorship activity have not been reflected in the accounts, such liability being looked upon as a "personal" obligation.

However, this does not warrant inclusion of personal assets and liabilities in the balance sheet of a proprietorship which purports to portray financial condition with respect to a particular business activity or segment of the individual's operations.

We believe there is fairly common agreement among accountants that they will have met their responsibility in reporting on proprietorship statements if they insist on a footnote to the statements or otherwise include a statement in their report to the general effect that

> The balance sheet includes only the assets and liabilities of the proprietor which relate to the business operating under the name of .... No liability has been reflected in the balance sheet for any taxes on income derived from the operations of the business but owed by the proprietor in his personal capacity, and the extent to which assets of the proprietorship may be used to pay any such liability or any other obligations personal to the proprietor, has not been determined.

Some accountants may also deem fit to add:

> The accompanying statements are based solely on such books, records, and underlying data as were made available to us.

It is also considered highly desirable that the heading of the financial statement clearly indicate after a trade name that a sole proprietorship is involved.

Inquiry **527**

Fixed asset jointly owned by husband and wife, and used in conduct of sole proprietorship business

"Inquiry is being made as to the proper accounting treatment of certain fixed assets of an individual proprietorship.

"We are referring specifically to a building used in the conduct of an individual proprietorship's business. Title is held jointly in the name of the individual proprietor and his wife. Is it proper to consider this building as belonging entirely to the individual proprietor? If not, please indicate the proper accounting of the same.

"In the instant case, can creditors of the individual proprietorship attach the building?

"To carry the example one step further, would it be proper to include on the balance sheet of this individual proprietorship under a heading such as 'Non-business assets' his personal residence if such was held jointly with his spouse?"

Our Opinion

It seems to us that the manner in which title to the building is held is not controlling on the question of whether or not to include the building among proprietorship assets. In our opinion, so long as the individual proprietor does in fact have an ownership interest in the building and such building is used in the conduct of the proprietorship's business, it forms part of the entity to be accounted for, and consequently should be included among the assets of the proprietorship.

It would also seem to follow that depreciation, maintenance and repairs, insurance, taxes, and other operating expenses incurred in connection with the building should be included in the income statement of the proprietorship. Of course, if the building were used partially for personal and partially for business purposes, only a portion of the above-mentioned expenses would properly be allocable to proprietorship operations.

The question whether creditors of the individual proprietorship may attach the building or whether the building may be levied on in execution of a judgment, is not within our province. We can only state that it is our understanding property held by joint tenants is attachable and leviable in New York State. What the situation is in the jurisdiction where your client is engaged in business, is for an attorney to say. It is not clear from your letter whether "held jointly" refers to tenancy in common, joint tenancy, tenancy by the entirety, or to community property. In certain circumstances, the question *might* arise whether the wife may be deemed a partner of the business.

From an accounting standpoint, however, we believe the rule of informative disclosure makes it desirable to disclose in the financial statements, the manner in which title to the building is held. That information has definite implications for creditors.

As for your client's personal residence: since it constitutes "Non-business assets," in our opinion, it has no place in a balance sheet for the proprietorship.

Inquiry **528**

Automobile used partly for business (proprietorship) and partly for pleasure

"I have been puzzled many times regarding the treatment on a sole proprietorship's balance sheet of an automobile which is partially used for business and partially used for pleasure. Should the 'portion' of the vehicle which is used for business be shown under fixed assets along with the reserve for depreciation, and should the 'portion' which is used for pleasure be shown under drawings?"

Our Opinion

Assuming, in a situation such as that referred to in your letter, that the automobile was initially paid for by a check drawn on the proprietorship's bank account, then in our opinion, a portion of the initial cost of the automobile based on the estimated ratio of business usage to total usage, should be recorded as a depreciable fixed asset of the proprietorship, and the difference between the total cost of the vehicle and portion of cost recorded as a depreciable fixed asset, should be charged to the drawings account. The portion of total cost recorded as a depreciable fixed asset, of course, would be the base for subsequent depreciation accounting purposes.

If gasoline, oil, and expenses of upkeep are also paid for by check drawn on the proprietorship's bank account, the charges should be split between "automobile operation and upkeep" expense and the drawings account in accordance with the respective ratios of business and pleasure usage to total usage.

If the automobile was initially paid for out of the personal bank account of the proprietor (rather than out of the proprietorship's bank account), then a portion of total cost based on the estimated ratio of business usage to total usage should be recorded as a depreciable fixed asset of the proprietorship and a correlative credit made either to the proprietorship capital account or to a liability account, depending on whether the proprietor wants to consider the portion of the expenditure allocated to the proprietorship, as a capital contribution, or as a proprietorship obligation currently owed to him in his personal capacity.

Also, if gasoline, oil, and expenses of upkeep are paid for out of the personal funds of the proprietor, then the proprietorship's share of such expenditures should be charged as "automobile operation and upkeep" expense of the proprietorship and a correlative credit made either to the capital or to a liability account.

Inquiry 529

Closing entries for cash-basis farmer and opening entries for accrual-basis farm corporation

"Recently one of my clients, a cash-basis farmer, decided to incorporate on January 1. His attorney advised my client that this constituted a tax-free incorporation, and all technical requirements therefor, such as percentage of stock ownership, were fulfilled. As of January 1, the client had the following assets (there were no liabilities) all of which were transferred to the corporation in exchange for 50,000 shares of $1 par value common stock:

Cash	15,000
Machinery, net	15,000
Raised wheat in storage	–0–

(Value $20,000, but not inventoried for tax purposes due to cash basis)

"Assuming the attorney was correct that this was a tax-free incorporation, I would like to have your views as to the closing entries on the client's personal records, and the opening entries on the corporate records. In addition, what would be the journal entry to record the subsequent sale of the wheat by the corporation for $22,000?"

Our Opinion

If we can properly assume that the newly-organized corporation intends to report *for tax purposes* on a cash basis, then we believe there are two approaches to the problem outlined in your letter, depending on whether the corporation intends to maintain its regular books of account (a) on the cash basis, or (b) on the accrual basis.

If by "closing entries on the client's personal records," you refer to closing out the accounts of the sole proprietorship (without reference to the unrecorded asset, namely, the inventory of wheat heretofore excluded from the proprietorship accounts because the client is a cash-basis farmer; and without reference to any other personal assets and liabilities not ascribable to the sole proprietorship), then we believe the following entry would be proper:

Dr. Capital – Sole Proprietorship	$30,000	
Cr. Cash		$15,000
Machinery, net		15,000

Thereupon, if the corporation will be on the *cash basis for both book and tax purposes,* in our opinion, the following entry on the corporation's books would be proper:

Dr. Cash	$15,000	
Machinery, net	15,000	
Stock Discount	20,000	
Cr. Capital Stock Outstanding		$50,000

[This discount, we believe, is a "true" stock discount to the extent of $6,000 for reasons stated later; and only "technically" a stock discount for the remaining $14,000, due to the fact that a cash-basis farm corporation would not record the inventory transferred to it (tax-deductible by predecessor) if its regular books are on a cash basis.]

On the other hand, assuming the corporation will maintain its *regular books of account on the accrual basis,* we believe the following entry would be proper:

Dr. Cash	$15,000	
Machinery, net	15,000	
Inventory of Wheat in Storage	20,000	
Stock Discount	6,000	
Cr. Liability for Deferred Income Tax		$ 6,000
Capital Stock Outstanding		50,000

(For purposes of illustration, this entry assumes a 30 per cent tax rate and that a zero basis attaches to the inventory of wheat; we believe the stock discount here is a "true," and not merely a "technical," stock discount, since an inventory of wheat having a fair market value of $20,000 but a zero tax basis is $6,000 less valuable than an inventory of wheat having both a fair market value and a tax basis of $20,000.)[1]

Upon subsequent sale of the wheat, the following entries may properly be made:

Dr. Cash	$22,000	
Cr. Sales		$22,000
Dr. Cost of Sales	$20,000	
Cr. Inventory of Wheat in Storage		$20,000

An accrual-basis income statement prepared thereafter should then reflect a Net Income before Taxes of $2,000, and a Provision for Income Taxes of $600. Assuming a 30 per cent tax rate and that a zero basis attaches to the wheat sold, the entry to reflect payment of $6,600 tax on the wheat sold would be:

Dr. Liability for Deferred Income Tax	$6,000	
Estimated Liability for Taxes on Accrual-Basis Income	600	
Cr. Cash		$6,600

[1] Regarding the matter of setting the wheat up on the books reduced by an allowance for taxes, the discussion at pp. 238-9 and p. 500 of the 7th and 8th editions of *Montgomery's Auditing* (Ronald Press Co., N.Y., 1949 and 1957, respectively) is relevant.

Inquiry **530**

Individual livestock feeder on cash basis — accounting problems upon incorporation

"I have a problem concerning financial statement presentation of specific items where the client maintains a set of records on the cash basis. The facts are as follows:

"A cash-basis individual who is in the business of feeding livestock forms a corporation, contributing to the corporation livestock having a cost to him and a fair market value of $350,000, and a raised and purchased feed inventory having a zero basis to him and a fair market value of $250,000, in exchange for stock of the corporation with a par value of $600,000. The corporation also maintains its books on a cash basis.

"The corporation subsequently feeds all the feed contributed by the stockholder, and purchases and feeds additional feed, and also has on hand at the end of the fiscal year, a part of the feed purchased during the fiscal year. The corporation also sells the cattle contributed, and purchases and has on hand a portion of these purchased cattle at the end of its fiscal year.

"My question is: What is the proper accounting for the feed and cattle, and the proper presentation on a statement of earnings on a cash basis for the fiscal year, and on a statement of assets and liabilities on a cash basis at the end of the fiscal year? Should the beginning amounts be charged off? If so, to what accounts should they be charged? Should the inventories continue to be carried on the books as assets? If so, at what figures should they be carried?

"There is much confusion in my mind as to the proper accounting treatment as contrasted with the income tax treatment of these items. Perhaps the solution is very simple, but at the present time, I cannot satisfy myself as to the proper financial statement presentation for accounting purposes."

Our Opinion

In our opinion, the situation outlined in your letter points up some of the essential fallacies of maintaining books and presenting financial statements on the basis of cash receipts and disbursements.

We note that *Statements on Auditing Procedure No. 28, Special Reports* (AICPA, 1957),* suggests the following opinion language for use when reporting on statements prepared on a cash basis, viz.:

> In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19. ., arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year.

The foregoing avoids use of the term "balance sheet" and substitutes "assets and liabilities . . . arising from cash transactions" for "financial position." If when on a cash basis, account balances properly to be carried forward to future periods necessarily represent "assets and liabilities arising from cash transactions," then *strictly speaking,* it would appear that the newly-organized corporation purporting to be on the cash basis should not even record the capital stock issued or the consideration (livestock and feed) received therefor. The issuance of stock for property is a non-cash transaction. However, it seems to us failure to record the corporate capital would be absurd, i.e., no accounting at all.

As a practical matter, if the corporate client persists in its intention to use the cash basis, it seems to us the livestock should be recorded at its cost which presumably is also its tax basis, and the feed inventory should initially be recorded at its fair value, *reduced, however, by an allowance for non-future-tax-deductibility,* upon issuance of the stock. The debit corresponding to the aforementioned allowance account would be a charge to *stock discount.* [If one were to charge the contributed livestock and feed immediately to surplus (!) on the ground that (*apart from* tax requirements respecting depreciable property and stock-in-trade held primarily for sale) the cash basis, strictly speaking, recognizes only one asset, namely, the balance of the cash accounts, then upon issuance of the capital stock, we would have a total capital impairment where there is only a partial capital impairment in fact – another absurdity.] Thereafter, upon sale of the contributed cattle, the corporation might charge off their recorded value to "cost of cattle sold"; similarly, the recorded value of the contributed

* Cf. *S.A.P. No.* 33 (AICPA, 1963) at pp. 88-9.

feed might be charged off to "cost of feed used," when used. If the contributed feed was thus charged off *gross*, then the allowance account would be treated as an offset to the income tax provision for the period. We suppose this treatment may be rationalized on "as if" grounds, i.e., that the result is the same as if the stockholder initially contributed $600,000 cash for the stock of the newly-organized corporation, and then the corporation disbursed the cash to acquire $350,000 worth of livestock and $250,000 worth of feed. According to a strict cash-basis rationale, we believe the cash disbursements would be immediately recognized as expired cost or expense, i.e., at the time when the livestock and feed are paid for, not when they are sold or consumed. (At this point, our alter ego queries: Would not the livestock and feed acquired upon expenditure of $600,000 represent "assets arising from cash transactions"? Possibly the answer to this depends on whether one has a pure-bred or hybrid concept of "cash basis.")

Also, we believe strict cash-basis accounting would require that the additional feed and cattle purchases during the fiscal year be expensed when paid for. (Of course, if the corporation were to deduct the additional feed and cattle purchase costs for tax purposes, but carry such additional unused feed and unsold cattle forward as inventory for book purposes, allowances for non-future-tax-deductibility would have to be set up thereagainst.)

Thus, as we see it, the corporation would end its fiscal year with only cash, capital stock, stock discount, and surplus (or deficit) accounts.

It should be made clear that we do not, of course, "sponsor" the foregoing cash-basis accounting treatments or procedures. We are merely indicating what we believe would be required by a strict cash-basis logic. It goes without saying, statements drawn up on any such basis usually would not portray financial position and results of operations, would result in unrecorded assets and liabilities, and accordingly, would not be very useful.

Accordingly, we would seriously suggest as a minimum that the corporation at its inception adopt *inventory accounting* for the purpose of determining periodically what might be termed its bare or basic cost of livestock sold and determining for periodic chargeoff its cost of feed consumed or used. You may want to consider the desirability of advising the client to adopt the accrual basis to the fullest extent practicable.

The suggestion that the client employ inventory accounting for the purpose of periodic determination of expired costs of livestock and feed does not appear unrealistic even from a tax standpoint, since the client is not a breeder or dairyman but is primarily in the business of feeding livestock. We note the following statements in the *Livestock Tax Manual* (National Livestock Tax Committee, Denver, Colo., revised edition, 1963):

(in commenting on "cash basis"):

> On the cash basis no inventories are used, either of supplies or of livestock, in the computation of taxable income although it is important that you keep a good record of livestock on hand. You cannot deduct currently the cost of animals purchased. If they are feeder animals you wait and offset their purchase price against their sale price in computing your profit when they are sold . . . . (p. 8)

(in commenting on methods of inventory valuation acceptable where accrual basis is used):

> (c) Cost, or cost or market, methods. Since it is practically impossible accurately to determine and allocate the cost of producing cattle, very few livestock producers use either of these methods, which are used in most other businesses. These methods are, however, frequently used by feeders, and "cost or market, whichever is lower," is a very sound method for a feeding operation because it reflects not only general market changes, but also the increase in weight and improvement in quality of your livestock on feed. (p. 10)

(in commenting on "Which is best, cash or accrual?"):

> If you are a livestock feeder, . . . , as opposed to a producer, the farm price inventory method may be very advantageous because it reflects the trend of market prices and the increment of feed consumed prior to sale. It flattens the hills and valleys of income, and makes it unnecessary to time your sales to fit your income taxes. (p. 12)

(in commenting on "ordinary income"):

> Ordinary income is realized when you sell your "stock in trade." . . . A feeder's stock in trade consists of his fed animals, and a breeder's stock in trade consists of those of his young animals which

he does not intend to hold as members of his own breeding herd .... (pp. 18-19)

Inquiry **531**

Regarding expert testimony, in bankruptcy case, on sole proprietorship's accounts and statements, "as submitted"

"We have been tendered engagement by a duly appointed, qualified, and acting trustee for a bankrupt under the cognizance of a United States District Court. Bankrupt is an individual who has operated a business in the sole-proprietorship form. The purpose of our engagement will be to provide expert testimony as to insolvency of the bankrupt during a four-month preference period beginning March 31, 1959, through July 30, 1959. The books and records available at present, are as follows:

1. A Cash Receipts and Disbursements Journal for calendar years 1958 and 1959. (No detail of receipts is given other than spread to sales columns or notation of receipts of loans.)
2. A file containing detailed lists of Accounts Payable at the close of each quarter during 1959.
3. Bank statements for the period under question and canceled checks (business account only).
4. A penciled Balance Sheet dated 3/31/59 with no identification other than initials which are the same as bankrupt's before the capital account.
5. A Profit and Loss Statement dated 3/31/59 with no other identification. The loss presented on this statement is the same as the loss shown on Balance Sheet of same date.
6. Penciled Balance Sheet and Profit and Loss Statements for period 1/1/59–6/30/59 identified with bankrupt's name.
7. Typed Balance Sheet and Profit and Loss Statement identified as bankrupt's for the calendar year ended 1959.
8. Prior years' tax returns.
9. A General Ledger which is presently lost, may be found; however, this is unlikely.
10. Lists of Accounts Receivable July 30, 1959.
11. In addition, we might note bankrupt has fled the area and may not return.

"The books and records indicated above appear to be for bankrupt's business interest only. The statements listed above indicate statement insolvency. We feel that this case presents a number of problems and would greatly appreciate any advice or recommendations you may have as to how we might solve them.

"First, we would appreciate your advising us whether or not we can give expert testimony only as to the business facet of the bankrupt's whole financial picture.

"Secondly, we would appreciate any recommendation you may have as to restrictions we should place on our testimonies.

"Thirdly, we would appreciate any pointers or recommendations you may have as to how we should go about presenting this case."

Our Opinion

Basically, we believe you should unequivocally qualify any opinion you may express on the financial position of the business of the absconded proprietor as being based on prima facie evidence, and then, only to the extent summary records have been furnished or submitted to you. If you are not in a position to "vouch" or audit such transactions as have been recorded let alone those which may not have been recorded, then obviously you cannot vouch for the accuracy or authenticity of either the records or statements.

Prima facie evidence is "evidence sufficient to raise a presumption of fact or establish the fact in question, unless rebutted." It appears this is about all you have in the case in question – what the lawyers might refer to merely as "*some* evidence." Also, it almost goes without saying, what you have to work with in this case, i.e., only certain summary records of the proprietorship to the extent made available, quite possibly may be only a *shred of evidence* relevant to the question of the absent individual's solvency or insolvency. As you know, determination of the latter may depend entirely on what assets and liabilities such individual has in his strictly personal capacity and the whereabouts of such assets.[1]

Inquiry **532**

Accounting for direct labor of proprietor in sole proprietorship

"I would greatly appreciate learning your views as to the best way to account for direct labor cost in an individual proprietorship, where the owner himself does a substantial portion of all labor.

"If it is desirable to establish a cost system, controlled by the general ledger, should an arbitrary rate be adopted for the owner's labor? If so, what contra account should be credited?

"Obviously, no cash outlay is involved, and there is no relationship to personal drawings which could not be a charge to a cost or expense account in the first place."

Our Opinion

Although this is a question of first impression with us, we believe the proprietor's productive labor cost could be handled in one of several ways, whichever more readily satisfies your needs.

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[1] For their general value or relevance, we urge your perusal of the following references:

1. *Treatise on Bankruptcy for Accountants,* by C. S. Banks (published by LaSalle Extension University, Chicago, 1948).
2. "The Accountant as an Expert Witness," by L. A. Pratt (in *The Certificate,* published by the District of Columbia Institute of Certified Public Accountants, January-February, 1949).
3. "CPA Services in Insolvency Trial Proceedings," by The Honorable Sherman D. Warner (in *The N.Y. CPA,* April, 1958).
4. "The CPA As An Expert Witness, From the Accountant's Point of View," by A. L. Baldwin (in *Technical Papers Presented at the 1950 Mountain States Accounting Conference,* Denver).
5. "The CPA As An Expert Witness, From the Lawyer's Point of View," by K. W. Robinson (in *Technical Papers, op. cit. supra*).
6. "Forensic Accounting," by M. Lourie (in *The N.Y. CPA,* November, 1953).
7. Inherent difficulties are involved in expressing an opinion on proprietorship accounts and statements under ordinary circumstances. But see the examples of reports on proprietorship statements in *Special Reports — Application of Statement on Auditing Procedure No. 28* (AICPA, 1960) pp. 17-25. This material might provide some helpful orientation insofar as it bears on any opinion you may care to express in the special circumstances of this case.

If the principal objective is one of estimating jobs for quoting a price *in advance,* you might time-study the operations on certain frequently-recurring jobs and compute the labor cost applicable to such jobs by pricing the productive labor hours involved. The owner's labor should, in our opinion, be priced at the going rate for his type of (presumably) skilled labor. If the price is to be set on a cost-plus basis *after* the job is performed, time records or cards might be maintained coded for particular jobs, with the labor hours of the proprietor priced at the going rate for his type of productive work. Here, the total cost of direct labor applicable to the job would be accumulated statistically for billing purposes.

On the other hand, if you wish to "tie in" the proprietor's productive labor to the regular direct labor account, possibly the client could maintain records of the proprietor's direct productive labor hours, price such time at the going rate, and then make a periodic entry charging direct labor and crediting, say, "proprietor's direct labor applied." At the end of a fiscal period, if any portion of the hypothetical charge for the proprietor's direct labor is included in closing inventory, then the balance of the "proprietor's direct labor applied" account should be closed out by allocating appropriate portions thereof to closing inventory and cost of sales (or alternatively, to inventory to the extent included therein, and transferring the remaining balance directly to the profit and loss account).

For statement purposes, cost of sales could be reflected inclusive of the portion of the proprietor's direct labor applicable thereto, and then reduced by such portion to arrive at cost of sales exclusive of the proprietor's direct labor; *or alternatively,* net income arrived at after inclusion of proprietor's direct labor in cost of sales, could be reflected followed by a special credit restoring "proprietor's direct labor applied" to income, with the *final figure* in the statement reflecting net proprietorship income as customarily conceived.[1]

[1] For an interesting related discussion, see the item "Is a Proprietor's 'Salary' Cost?" which appeared in Carman G. Blough's column at pp. 76-7 of the August, 1955 issue of *The Journal of Accountancy.*

Non-profit Organizations

DEPRECIATION ACCOUNTING

Inquiry 533

Depreciation accounting in non-profit organizations, particularly colleges and hospitals

"Perhaps you can assist me with the following:

"I am seeking to determine whether the Institute recommends one particular policy with respect to setting up depreciation reserves against fixed assets in non-profit organizations such as colleges and hospitals.

"I find the practice varies, and it seems to be directly related to the desire to make a showing of the capital account of an institution.

"I would appreciate any references you have on the subject."

Our Opinion

The only Institute publication dealing with accounting and auditing for hospitals is *Case Studies in Auditing Procedure No. 11, A Hospital* (1956).

The Institute has not as yet taken any official position in any of its bulletins regarding the propriety of the use of depreciation accounting in non-profit organizations, particularly colleges and hospitals.

However, *directly following* is some correspondence we had with another Institute member some time ago which we believe you will find helpful. We are also appending to such correspondence some additional citations dealing with the matter in question.

Reply to Institute Member

As of this writing, no Institute committee has ever commented or published a statement on the reasonableness of taking depreciation in non-profit organizations. Frankly, we do not feel that we have sufficiently crystallized our own thinking on this particular matter. Accordingly, we hesitate to generalize on the question except to state that depreciation accounting may be found to serve a useful purpose in the case of some types of non-profit organizations, while for other types of non-profit organizations, it may be found superfluous. In this non-profit area, basically the question of employment or non-employment of depreciation accounting is related to, or dependent on, *financial and fund-raising policy* of the organization; whether rates charged for certain activities are to be on a *self-sustaining* basis and whether total costs of such activities are to be accumulated as *supportive* of such rates; whether operations of the year of replacement are to be saddled with the entire cost of replacement or replacement costs spread over a number of fiscal periods; and whether the cost of plant in use is to be reflected in the balance sheet of the particular organization.

For whatever value they may have, we make the following additional comments:

In *Accounting for Community Chests and United Funds — Principles and Methods* (United Community Funds and Councils of

America, Inc., N.Y., 1956) a Standard Chart of Accounts is presented. The chart of Operating Fund Accounts lists "Furniture and Fixtures" and "Land and Buildings" among the asset accounts and also lists "Depreciation Allowance – Furniture and Fixtures" and "Depreciation Allowance – Land and Buildings" as contra-asset accounts. In addition, however, accounts entitled "New Equipment" and "Repairs and Replacements to Furnishings and Equipment" appear among the expense accounts. The following comment is made at p. 27 with respect to the "Depreciation Allowance – Furniture and Fixtures" account, viz.:

> *Usually*, the investment in furniture and fixtures is charged off to the nominal amount of $1. If this is done, there will be no need for this account (*emphasis ours*).

Whether rightly or wrongly, it seems clear from the above that most chests or charities do not employ depreciation accounting.

In a later publication, *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* (National Health Council *and* National Social Welfare Assembly, 1964) the accounting for Land, Buildings and Equipment is discussed at pp. 13-21. See also Exhibit H at pp. 108-09 and Notes to Financial Statements No. 7 at p. 111. The essential position taken by this publication may be gathered from the following quoted excerpts, viz.:

> The cost of all fixed assets purchased by an agency should be included in the expenditures section of its statement of income and expenditures for the year of their acquisition. (p. 16)

> The accounting required of an agency in order to incorporate in its balance sheet assets previously charged off to expense is quite simple. . . . Concurrently, then, with reporting substantial fixed asset acquisitions as current year expenditures, voluntary agencies should incorporate the acquisitions in the Equity in Land, Buildings and Equipment fund group. This requires no more than addition of the values of the assets acquired, on the one hand, to the appropriate fixed asset balances in this fund group and on the other hand, to the fund balance, "Investment in land, buildings and equipment." (p. 20)

> An agency that desires to recognize the reduction, with time, of the value of its buildings and equipment without setting aside funds for their replacement may do so, but only by direct reduction of the assets, and of the investment account, in its "Land, Building and Equipment Fund": no "depreciation" charge for

such adjustment may be recorded in its statement of operations. (pp. 17-18)

If depreciation accounting is not employed by a non-profit organization, we believe expenditures for fixed assets should be reflected in its income statement as a special charge, since such expenditures are frequently "material and extraordinary" in nature.

An example of this treatment may be found in the "Summary of Income and Expenditures" contained in the annual report of The American National Red Cross for the year ending June 30, 1953, viz.:

Excess of Income Over Operating Expenditures (In 1952 – Excess of operating expenditures over income)	$2,311,139	($13,642,729)
Other Charges – For acquisition and construction of land and buildings	631,290	80,706
Excess of Income Over Operating Expenditures and Other Charges (In 1952 – Excess of operating expenditures and other charges over income)	$1,679,849	($13,723,435)

One of several treatments followed by non-profit organizations in accounting for their fixed assets is that of reflecting fixed asset costs on the balance sheet regardless of the fact such costs have also been included as an item of "expense" in the statement of income. This particular treatment, it seems to us, is "sui generis," in a class by itself. It is neither a retirement method, a replacement method, nor a retirement reserve method. The chief function of such a balance-sheet account is statistical; it presumably reflects the cumulative costs of fixed assets in use.

The majority practice, however, of carrying the fixed assets at nominal value is indicated above. The "General Funds" balance sheet in the report of The American National Red Cross includes an item "Land and Buildings (at nominal value of $1.00 for each parcel)."

It seems to us that if fixed assets are to be set up at cost on the balance sheet despite the fact such cost has already been included in the income statement, then there must be a contra-credit to a surplus acccunt.

Some miscellaneous facts and references relevant to the accounting for fixed asset expenditures by non-profit organizations or institutions, follow:

INQUIRY: 533

a. L. Roeder's article on "Church Accounting" in *The New York Certified Public Accountant* for November, 1950, indicates that "Labor and material for repairs and improvements to buildings and equipment; (and) purchases of equipment" are charged off as expense.

b. The chart of accounts included in *Non-profit Hospital Service Plans,* by C. R. Rorem (American Hospital Association, Chicago, 1940) lists balance-sheet accounts such as "Cost of Furniture and Equipment" and "Reserve for Depreciation"; "Depreciation" is also listed among the Operating Expenses. Express recommendation is made "that a record of the original cost of . . . equipment should be maintained, with appropriate adjustments of the values resulting from use and general obsolescence." Although the reference here is probably to systematic depreciation accounting, the language is redolent of the practice followed by some nonprofit organizations of making a direct writeoff of the cost or a portion of the cost of plant items after periodic or not-so-periodic appraisal thereof to determine "observed depreciation."

c. J. S. H. Weiner in an article, "The Inclusion of Depreciation of Hospital Plant and Equipment with Operating Costs" (*The N.Y. CPA* for August, 1951, pp. 551-4), outlines three prevailing views concerning "treatment of depreciation with respect to hospital costs," and makes one of the most effective arguments we have seen for full-fledged depreciation accounting in this area.

d. Jesse B. Cogen in an article, "Accounting for Non-Profit Fund Raising Organizations" (*Accounting Seminar* for May, 1948), makes the following statement: "Depreciation reserves are carried on the books, because it is generally felt that it would be grossly unfair to any one campaign to charge it with expenditures which are generally large and have an estimated life of several years." Mr. Cogen's particular experience here was as Controller of the United Jewish Appeal.

e. The article, "Audit of Charities," by E. M. Schwerin (*The Spokesman,* Pennsylvania Institute of CPAs, June, 1952) sets forth a chart of accounts which lists "replacements" among the fixed charges to operations. There is some indication that initial expenditures for buildings, furniture and fixtures, apparatus, etc., are capitalized.

f. See under subheadings, "Plant Additions and Equipment" and "Depreciation," in R. S. Johns' article, "Authoritative Accounting Guide for Nonprofit Institutions," at p. 303 of the March, 1954, issue of *The Journal of Accountancy.*

Regarding the appropriateness of the use of depreciation accounting for hospitals, see the following:

1. "A Review of the Place and Function of Depreciation in Hospital Accounting," by Lloyd Morey (*The Modern Hospital* for September, 1953, at p. 73).
2. "Depreciation in Hospital Accounting" (exchange of views between P. D. Shannon, L. Morey, and H. E. Klarman, in *The Modern Hospital* for January, 1954, at p. 84).

For an excellent comprehensive discussion of depreciation accounting for colleges and universities, see:

Appendix B dealing with "Depreciation of Real Property in Educational Institutions" (pp. 143-51) in *College and University Business Administration* (American Council on Education, Washington, D.C., 1952, vol. 1).[1]

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[1] For additional references dealing with depreciation accounting in non-profit organizations:

1. *Hospital Accounting — Principles and Practice,* by T. L. Martin (Physicians' Record Co., Chicago, 1958). See Index at p. 293 under the heading "Depreciation."

2a. "Accounting Principles and Procedures of Philanthropic Institutions," by L. Englander.

b. "The Formulation of Accounting Principles for Nonprofit Institutions," by R. L. Dickens.

(The above articles which appeared in the April, May, and June, 1958 issues of *The N.Y. CPA* discuss depreciation accounting at pp. 281-2, 342, 401, 403, 404, 405 and 414, respectively.)

3. "How to Figure Depreciation," by R. Penn (from *The Modern Hospital,* May, 1956).
4. "Capital Expenditures and Depreciation for Non-profit Institutions," by E. W. Baldassare (in *The N.Y. CPA* for March, 1959, at pp. 206-12).
5. *Uniform Chart of Accounts and Definitions for Hospitals* (American Hospital Association, Chicago, 1959) see pp. 80 *et seq.;* p. 128.
6. Schep's *Accounting for Colleges and Universities* (Louisiana State University Press, Baton Rouge, 1949) p. 255.
7. J. K. Lasser's *Handbook of Accounting Methods* (D. Van Nostrand Co., N.Y., 1954) p. 371.
8. "The Impact of Third-Party Payments on Hospital Economics," by C. R. Rorem (in *Proceedings* of 11th Annual Institute on Hospital Accounting, Indiana University Bulletin, Summer, 1953).
9. "Depreciation in Hospital Accounting" (in Carman G. Blough's column in the April, 1948 issue of *The Journal of Accountancy*).
10. See exchange of views between L. Morey and C. F. Coates at p. 725 of the December 1953, p. 479 of the April 1954, and pp. 23, 26 and 28 of the July 1954 issues of *The Journal of Accountancy.*

N.B. At the time of editing this material, the AICPA's Committee on Relations with Non-Profit Organizations had an audit guide entitled "Audits of Voluntary Health and Welfare Agencies" in preparation for early publication. A draft of the guide contained a discussion of "Fixed Assets and Depreciation."

INQUIRY: 533

Inquiry 534

Depreciation on university housing and boarding (auxiliary) facilities

"Please send to us such information as you might have concerning income reporting for universities on housing and boarding departments.

"Specifically, the problem that we should like information about concerns the propriety of charging current operations with the necessary payment to pay interest and amortize the loan negotiated to build housing and boarding facilities.

"It would seem that since the life of the facilities coincides with the amortization period of the loan, and since the university concerned is diligently trying to set the rates for board and room at a figure which is expected to yield only a small profit, it would, therefore, not be necessary to consider depreciation in determining monthly and annual operating results."

Our Opinion

The publication *College and University Business Administration* (American Council on Education, Washington, D.C., 1952, vol. 1) deals with depreciation at pp. 73-4, 76-7, 83, 86-8, 95, 97-8, and under the heading "Depreciation of Real Property in Educational Institutions" at pp. 143-51.[1] Note the statement therein at p. 151 that

> Depreciation should be accounted for on property used by the auxiliary enterprises and activities in order that the total cost of operating these activities may be known, and as an aid in determining rates of fees and other charges. *If it is expected that this property will be replaced out of the income of the activities, it is essential that depreciation be accounted for.* (*our emphasis*)

In view of the foregoing, it seems to us if the policy and intention of the university in the case described in your letter is to replace the property by *refinancing* rather than "out of the income of the ac-

[1] See also p. 255 of Schep's *Accounting for Colleges and Universities* (Louisiana State University Press, Baton Rouge, 1949), and p. 371 of Lasser's *Handbook of Accounting Methods* (D. Van Nostrand Co., N.Y., 1954).

tivities," it would be proper to make periodic charges in lieu of depreciation to operations in amounts equivalent to debt service payments on the loan negotiated to build housing and boarding facilities. The charge might be given a designation such as "Appropriation to Auxiliary Plant Fund for Debt Amortization." Obviously, in order to be in a position to replace auxiliary property with its own funds as well as amortize its building loan, a university's rates would have to be set sufficiently high to cover both the depreciation and loan amortization factors. Ordinarily, we believe a university would not countenance making a provision for both factors in setting its rates.

Although removed from the educational field, you may be interested to know that the New York Port Authority includes a charge in its operating statement for Debt Service (interest on funded debt, serial maturities and sinking fund requirements, etc.). A note to the financial statements reads as follows:

> Deductions are made from revenues and reserves equal to payments to sinking funds and other principal payments on debt. These deductions are credited at par to the (balance sheet) account "Debt Retired Through Income," and constitute the effective recovery of facility costs. Therefore, no separate deductions for depreciation are required.

HOSPITALS

Inquiry 535

Unrestricted gifts and grants received by non-profit hospital — is direct exclusion from general fund permissible?

"We would like to have your opinion concerning a question of accounting for *unrestricted* gifts and grants (donations) received by non-proprietary hospitals.

"First, it should be noted that the manual *Bookkeeping Procedures and Business Practices for Small Hospitals* (American Hospital Association) provides for the reporting of such donations in the account

General Contributions, in the Other Income section of the Income and Expense Summary of the General Fund (see p. 31 and p. 116 of the above manual).

"Our question is this: Would it be permissible to report such donations, or some portion thereof, *alternatively* as credits to a Special Fund or a Temporary Fund rather than as income of the General Fund *if* the board of trustees of the hospital so directs? Such treatment of the unrestricted donations would be fully disclosed in a footnote to the Income and Expense Summary, stating that 'donations of X amount had been credited to the Special (or Temporary) Funds by action of the board.' The effect of such treatment is, of course, to reduce the reported net income for the year by the amount of such donations so 'transferred' to the Special or Temporary Fund. A related question is this: Would it then be permissible in subsequent year(s) to transfer some or all of the amount so treated to the General Fund and report it as current income of those year(s)? Or, alternatively, to use the funds for some special purpose in future years without first running them through General Fund income?

"For your information, such treatment appears to be permissible in the case of 'college and university accounting,' as indicated on page 67 of the publication *College and University Business Administration* — vol. 1 (American Council on Education).

"We will appreciate having your views on this matter. Will you include, if possible, references in the area of hospital accounting to which we could refer concerning this?"

Our Opinion

We have examined several leading references discussing the question of accounting for unrestricted gifts, grants, legacies and donations received by non-proprietary hospitals or other non-profit organizations, and while it appears that alternative treatments of unrestricted gifts, grants, etc., are in fact employed in practice (i.e., including such items in current or General Fund income *or* directly crediting same to Temporary or other funds), nevertheless we also get the impression that a majority view as to proper treatment is developing.

One authority supporting the first reference cited in your letter [*Bookkeeping Procedures and Business Practices for Small Hospitals* (American Hospital Association, Chicago, 1956) at pp. 31 and 116], which provides for the reporting of such donations in the Other Income section of the General Fund, is C. G. Roswell's *Accounting, Statistics and Business Office Procedures for Hospitals* (United Hospital Fund of New York, N.Y., 1946). At p. 78, Roswell states

> It is important to bear in mind that all income received by a hospital, unrestricted at the time received and therefore available for current operating purposes, should be reported as supplementary income. Subsequent action of the governing board in appropriating such income for a special purpose should be treated as a direct appropriation of General Fund Surplus.

Also, at p. 64, Roswell states the following:

> All income which when earned or received, may be expended for current operating purposes should be included in this statement (of Income and Expense) regardless of the designations or restrictions subsequently placed on such income by the governing board of the hospital.

Incidentally, regarding your second specific question, note Roswell's description of "Supplementary or Other Income" at p. 72 in which he includes "transfers of income from temporary funds." Before leaving Roswell, perhaps we should call your attention to the Comparative Summary of Income and Expense at p. 66. It seems to us that the Statement would be improved if the "Unrestricted Legacies and Bequests" were listed just beneath "Contributions." Even if this change were not made, we believe it would be somewhat clearer to designate the third item from the bottom of the Statement as the "Excess of Operating and Other Expenses Over Operating and Supplementary Income."

T. L. Martin in his *Hospital Accounting — Principles and Practice* (Physicians' Record Co., Chicago, 1958) also indicates at p. 158 that "all gifts or donations for General Fund purposes will appear as other revenue" in the Statement of Income and Expense for General Fund. Note also at p. 132 his statement that "The governing board of a hospital may authorize by resolution the transfer of an unrestricted gift or legacy to the permanent fund." We infer from use of the word "transfer" in the above passage that the unrestricted gift or legacy need first be recorded as General Fund income.

The only references we have been able to find which expressly indicate that an unrestricted gift or legacy may be credited directly to a fund other than the General Fund, i.e., without first being reported as General Fund income, are *College and University Business Administration*—vol. 1 (American Council on Education, Washington, D.C., 1952, at p. 67), which you cited in your letter, and L. Englander's "Accounting Principles and Procedures of Philanthropic Institutions—Part One" (in *The N.Y. CPA* for April, 1958, pp. 273-88). At p. 280 of the Englander article, however, you will note that he is merely pointing out the fact that unrestricted legacies *are* recorded in alternative ways. However, he later states that "in reporting to the general public, it must be remembered that such legacies constitute unrestricted income, and *must* (*our emphasis*) be reported as such."

Personally, we feel that *College and University Business Administration* which is such an excellent guide in so many other respects, does a disservice by sanctioning the practice of initially crediting unrestricted gifts or legacies directly to a fund other than the General Fund, on board "designation." We seriously question the propriety of the practice of "designating" or "deferring" certain unrestricted gifts, bequests, and legacies, thereby excluding them from current operating income, because of the manipulative possibilities inherent in such practice. The rule of consistency as affecting fair presentation requires that *all* unrestricted gifts, bequests, and legacies be reflected as current operating fund income when received.

It should be mentioned that alternative methods of presenting in the current fund statements, appropriations or transfers of unrestricted gifts, bequests, and legacies to special or other funds, have been discussed from time to time. Such alternative methods of presentation include showing the appropriations as a deduction from gross operating income, as a deduction from net operating income, and as a charge against current operating fund surplus. Personally, we are inclined to disfavor the first-mentioned alternative method of presentation.

Inquiry **536**

Non-profit hospital — treatment of unpaid pledges receivable and fund-raising costs of building campaign

"The following problem has arisen in our practice, and we have been unable to find a definitive answer in published literature at our disposal. We seek your guidance and advice.

"A non-profit hospital corporation engages a professional fund-raising organization to conduct a campaign for a new building program. At the close of the year on which we are reporting, $20X has been pledged. Of these pledges, $10X has been collected and the costs to date of the campaign have been paid amounting to $1X of fund-raising organization's fees, advertising and other expenses.

"The following questions arise:

"1. Should the unpaid pledges receivable of $10X be included in the balance sheet under plant fund?

"2. What amount should be credited to the plant fund capital account at this point, $19X, $9X or $10X (in the latter case, permitting the $1X of expenses to be charged to expenses of the general operating fund)?

"Primarily, the second question is whether or not it is permissible under sound accounting principles to set up funds raised in the plant capital fund account on a gross basis, and to charge the cost of raising such funds to general operating fund expenses."

Our Opinion

In our opinion, the unpaid pledges receivable of $10X should be included in the balance sheet under the plant fund and $19X should be credited to the plant fund capital account at this point. One refinement might be to reclassify two portions of the $19X, one as an offset account to the pledges receivable and the other as a liability of the plant fund, representing estimated allowance for uncollectible building fund pledges and estimated liability for remaining fund-raising costs, respectively.

Louis Englander in his *Accounting Principles and Procedures of Phil-*

anthropic Institutions (pub. by N.Y. Community Trust, 1957), states (at p. 10) that "Most philanthropic institutions . . . do not consider pledges as income until the pledges are paid. . . . They record income on a cash basis. . . . Where unpaid pledges are included in income, the pledges receivable are set up with corresponding provision for uncollectible pledges, so that only the amount expected to be collected actually finds its way into income." Be this as it may, the accrual method is always a proper method; and in this connection, you will note at p. 25.76 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) that Charles G. Roswell, author of *Accounting, Statistics and Business Office Procedures for Hospitals* (United Hospital Fund of New York, 1946) recommends that accounts for hospitals be maintained on the accrual basis.

The statement at the top of p. 25.76 in the *Handbook,* viz.: "The general fund is employed to account for the *regular operations* of the hospital," would tend to support the conclusion that all of the transactions referred to in your letter should be handled within the plant fund. All of which is *not* to say that, if properly authorized in a given case, a general fund may not pay for the costs of a special fund-raising campaign or appropriate money therefor. Theoretically, we believe if, after proper authorization, an appropriation were made in a general fund to cover the costs of obtaining money to be used in constructing a building, some sound arguments could be advanced for capitalizing such costs in the restricted plant fund as part of the costs of construction.

As a general rule, however, we believe that the costs of raising funds should "follow" the funds raised, be paid for out of such funds, and be recorded within the same fund as the special campaign income.

Incidentally, at p. 95 of *Hospital Accounting – Principles and Practice,* by T. L. Martin (Physicians' Record Co., Chicago, 1958) we note a Plant Funds balance sheet containing the items "Building Fund Pledges" and "Reserve for Uncollectible Building Fund Pledges." The correspondence which *directly follows* is also quite relevant to the questions raised in your letter.

Inquiry **537**

Capitalization vs. expensing of hospital's fund-raising costs

"We have a theory problem in accounting on which we have not been able to reach a conclusion, and are accordingly requesting your advice. This problem is concerned with an audit of a non-profit hospital on which we must render an unqualified opinion.

"Approximately one and a half years ago, the board of trustees of this hospital decided to launch a fund-raising campaign so as to be able to expand the physical facilities of the buildings and equipment. Total fund-raising costs approximate $25,000, which includes advertising, office supplies, contract labor, office salaries, and miscellaneous other costs. We would like to know whether these fund-raising costs should be added to the cost of the building constructed with the funds raised or if the cost should be considered merely a charge against funds raised, resulting in a net funds received. Some hospital equipment was also purchased with funds received, and we wonder whether some of the fund-raising costs should be added to the cost of the equipment purchased. In other words, if the costs are added to the cost of assets purchased, they apparently should be prorated to the assets. Due to other circumstances, it would be to the hospital's benefit to capitalize these costs and depreciate them over a period of time. This fact, of course, actually has no bearing on whether or not the costs should be capitalized."

Our Opinion

We talked to Charles G. Roswell, author of *Accounting, Statistics and Business Office Procedures for Hospitals* (United Hospital Fund of New York, 1946), and he stated that the general practice is to charge fund-raising costs against the funds raised, i.e., against the so-called "Contributions Restricted for Building Purposes." He stated that this treatment is of increasing concern because depreciation is being accepted as a cost by some third-party agencies billed for medical services, and such agencies would be inclined to consider the capitalization of fund-raising costs as "padding."

One other CPA with whom we discussed this matter also stated that in connection with a fund-raising campaign for a new building for a private school client, his firm charged the fund-raising costs against the gross contributions received.

It is noteworthy that "Fund-Raising Expenses" is included as one item under the general heading of "Depreciation, Interest, and Other Expenses" in the classification of expenses for the General Fund appearing in Mr. Roswell's book. However, Mr. Roswell explains that the fund-raising expenses chargeable to the General Fund's operations would include only expenses incurred in appealing for unrestricted funds to be used for current or general operating purposes.

Inquiry **538**

Hospital accounting — treatment of provision for loss on doubtful accounts as gross revenue adjustment or as operating expense

"You may recall that we had some previous correspondence regarding hospital accounting.

"The question with which we are presently concerned is whether a provision for loss on doubtful accounts should be shown as a reduction of operating revenues or shown as an item of expense in the operating statement. We are trying to determine which of the two methods is proper in the handling of this account in the statements of a hospital.

"*Case Studies in Auditing Procedure No. 11, A Hospital* (AICPA, 1956) shows the item of provision for loss on doubtful accounts as expense. On page 32 of that case study, a notation is made that the firm which did this case study considers the provision as an expense item from the point of view of generally accepted accounting principles but refers to the fact that the American Hospital Association *Handbook* considers this item as a deduction from gross income.

"The American Hospital Association is generally considered an authority on hospital accounting. The AHA *Handbook*, Section One, published in 1950, stated that the provision for loss on bad accounts should be shown as a deduction from revenue. The AHA *Handbook*, Section Two, published in 1956, takes the same position. The AHA *Handbook*, known as the *Uniform Chart of Accounts and Definitions for Hospitals*, also states that the provision for uncollectible accounts should be shown as a deduction from operating revenues and not as an expense. This last book was published in 1959 and is a revision of the AHA *Handbook,* Section One.

"The American Association of Hospital Accountants has promoted the use of the handbooks mentioned in the preceding paragraph. That association is in agreement with the American Hospital Association that the provision for loss on doubtful accounts should be shown as a reduction of operating revenue and not as an expense item.

"May we have your comments?"

Our Opinion

The AICPA has never taken an official position as to the manner of treatment of provision for loss on doubtful accounts.

As the discussion at pp. 5.22-3, 11.24-5, and 11.27 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) indicates, the question you raise is an unresolved one.

In our opinion, the arguments for treating the provision for loss on doubtful accounts as an adjustment of sales carry greater conviction than the arguments for treating it as a financial expense or loss, or as a selling and administrative expense, especially in cases where the provision for doubtful accounts is based on the past relationship between experienced bad debts and net sales, and the proportions of cash and credit sales remain relatively constant. In such cases, net sales revenues would then be stated at estimated net realizable value.

On the other hand, if an organization follows the practice of aging its outstanding accounts receivable balances for the purpose of computing an adequate allowance which when applied as an offset to such accounts receivable would reduce them to their estimated net realizable value, then any provision for doubtful accounts may merely represent the amount required to increase the allowance to the amount deemed adequate, and if such provision were then reflected as an adjustment of sales, it would not necessarily reduce such sales to their estimated net realizable value. One of the principal arguments for treating bad debts provisions as an adjustment of sales, of course, is that it places such sales on a realization basis.

INQUIRY: 538

COLLEGES AND UNIVERSITIES

Inquiry **539**

Asset status of funds held in trust for college or university by others

"We need your help in determining the generally accepted practice for presentation of a bequest on the balance sheet of an educational institution.

"When the Testator died in October, 1956, he bequeathed to the University 3 per cent of the principal and income of the residuary trust estate after providing specific bequests to various individuals.

"In audit reports which we have submitted heretofore, we have called this to the attention of the reader by footnote. At the last meeting of the Board of Trustees, a resolution was passed, directing us, if we could possibly see our way clear to do so, to record this as an asset on the balance sheet. As you will see from the resolution, the Administration has been faced with an operating deficit for some years and the Board wishes to use the proceeds of this bequest to eliminate the deficit.

"The Executors of the Testator's Estate have filed annually with the County Judge a report prepared by a national firm of CPAs as of September 30, the last being filed as of September 30, 1960. In keeping with the intent of the deceased, the Executors have begun to move the assets from the Estate into a Trust which must be terminated twenty years from the death of the benefactor.

"Does current practice permit us to record this bequest on the balance sheet of .... University? If so, at what value? Value becomes highly complicated in view of the fact that since the Testator's death, the firm of which he was a principal has been incorporated, and the Trust now owns stock in the corporation. Also, the values used in setting up the Trust were the current values at the time the assets were transferred into it."

BOARD OF TRUSTEES' RESOLUTION

WHEREAS the University is the beneficial owner of a 3% distributable share of the .... Trust Fund, the use of which is unrestricted, and

WHEREAS it has been reported to this Board that the Trustees of the .... Trust have distributable assets valued in excess of twenty million dollars (and in addition thereto own the interest of Testator in the now-incorporated firm of which Testator was principal partner) and that distributions can be expected at regular intervals from said Trust to University, and

WHEREAS it thus appears that the interest of the University in said Trust exceeds the current fund accumulated deficit, and

WHEREAS the Trustees have not heretofore determined the most appropriate use of said Trust,

NOW, THEREFORE, BE IT RESOLVED that in the future as and when distributions are received from the University's share in the Trust, the entire amount so received shall be applied to reduce the current fund accumulated indebtedness and no portion of the funds, principal or interest, shall be used to pay current operating expenses unless this Board shall subsequently determine that such use is imperative, and

BE IT FURTHER RESOLVED that the auditor of the University make as accurate an estimate as practicable, from the public records in the County and from other data available to him, of the present value of the interest of the University in said Fund, and reflect this estimated interest in the consolidated balance sheet of the University, and indicate in the audit of the University that these funds have been dedicated to the orderly retirement of the current deficit.

Our Opinion

In our opinion, it is proper to give asset status to the university's equitable interest or vested remainder in the corpus of the trust established under the will of the testator; and this conclusion is supported by current practice. The most authoritative publication on the subject of college and university accounting, *College and University Business Administration* (American Council on Education, Washington, D.C., 1952, vol. 1, at p. 18) states that

> Funds held in trust by others include funds which are not under the control of the institution, but are held for its benefit by a trustee or other agency designated by the donor. *It is desirable to include such funds on the balance sheet* in order to show the total endowment resources of the institution. (*our emphasis*)

The recommended form of balance sheet appearing at pp. 48-51 of the above-cited publication, under major caption III, "Endowment and Other Non-Expendable Funds," includes an asset and liability subcaption designated "Funds held in trust by others." At p. 42, the publication makes the following statement, viz.:

> Funds Held in Trust by Others frequently presents difficult problems of evaluation since the institution may not be able to obtain complete information with reference to the assets held by the external trustee. In this situation a nominal value may be used, and a proper notation should appear as a balance sheet footnote.
>
> In the case of a fund established for the benefit of a number of institutions, with no provision as to the amount of the principal belonging to each, the only provision being with respect to the allocation of income, it is desirable that each institution include among its endowment assets that proportion of the fund represented by its proportionate share of the income, if that is known. Otherwise, the situation should be indicated by a footnote on the balance sheet.[1]
>
> The caption Funds Held in Trust by Others does not include funds under the control of the institution which are administered by a trust company or other custodian as the agent of the institution itself.

As one example, we note in passing that the University of Illinois, in its balance sheet at June 30, 1960, follows the form recommended in the above-cited publication. The balance sheet includes the item "Funds Held in Trust by Others." The University of Michigan, on the other hand, employs somewhat different terminology in its report; i.e., Endowment Fund Assets appear under the three main custodial classifications, "In custody of University," "In custody of State Treasurer," and "In custody of non-University trustees designated by donors." Under the latter classification, in addition to "Cash," appears the following item:

"Marketable Securities, approximate market
$9,557,000 at 1960 ....$4,355,193."

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[1] In the case in question, it is clear that the university has a vested remainder in 3 per cent of the principal of the trust as well as having a 3 per cent beneficial interest in income. However, this quoted paragraph makes reference to funds "established for the benefit of a number of institutions, with no provision as to the amount of principal belonging to each. . . ." For purposes of further clarification, it seems to us that if an institution does not in fact have a vested remainder in a principal fund, then no asset status should be given to any portion of such principal (corpus) on the institution's statements, since it has no "future interest" or estate in this respect. On the other hand, if an institution has a beneficial or equitable interest in the income of a trust, there is a basis for giving asset status to such beneficial interest, measured at a nominal amount if the annuities to be received are to be variable and unpredictable or at present discounted value if the annuities are to be level in amount for a fixed term of years. See the relevant correspondence *directly following* this reply.

Respecting the matter of evaluation, the following *reconciling item* which appears in the reconciliation of beginning and ending Endowment Fund balances for the year 1959, is also noteworthy, viz.: "Cost of investments in custody of certain non-University trustees designated by donors previously recorded at nominal value of \$3 . . . \$2,142,268." In other words, in 1959, certain of these assets were written up from a nominal value to "cost," presumably cost or carrying value as it appears in the accounts of certain trusts.

Regarding the carrying value to be assigned the item in question, we personally would be inclined to value the university's interest in the trust as remainderman at 3 per cent of the value assigned corpus at the date the trustees made their opening entry. (As you know, the basis for the trustees' opening entry is the inventory of assets received from the executor of the estate upon a decree settling the executor's account. The properties are recorded in appropriate accounts at their values as at the date they are received by the trustee.)

In this connection, it is relevant to point out the following statements at p. 18 of *College and University Business Administration* (*op. cit. supra*):

> Securities and other property donated to an institution should be recorded in the accounts at market value or at an expertly appraised value as of the date of the gift.
>
> The book values of investments in this fund group should not be changed to reflect fluctuations in market prices.

On the basis of the last paragraph of the copy of the board's resolution, it is ambiguous as to just what the board intended to convey by the term "present value of the interest of the University in said Fund," i.e., whether "present value" refers to current fair or appraised value or to present discounted value in the actuarial sense. Since the university's interest in the remainder will doubtless fluctuate in value during the next twenty years to an unpredictable extent, and since the annuities to be received as income beneficiary over the next twenty years are probably not fixed in amount but variable (or irregular) annuities, any actual estimate as to the present discounted value of both the series of payments and the ultimate distribution of corpus to be received, would at best be of somewhat questionable accuracy. Accordingly, we would personally be inclined to eschew using the actuarially computed value, at least in the balance sheet proper. If 3 per cent of the value at which the inventory was entered in the trustees' accounts is used, it would, of course, be proper to disclose estimated current value of the interest as determined at a given date, in a footnote to the balance sheet; or alternatively, a footnote keyed to the item in the balance sheet might merely state what the carrying basis of the item is and that such carrying basis does not purport to represent *either* an immediately realizable value *or* the current fair value of the interest.

Inquiry **540**

Trusts established, where several colleges named as income beneficiaries

"In making annual audits of small colleges and seminaries, we often are confronted with the following problem: A donor will set aside in a trust fund capital stock of a corporation of which he is usually majority stockholder and/or managing officer. The trust will usually be set up with a number of colleges sharing in the *income* from the capital stock as endowment income for the colleges. The corpus of the trust will never become the property of the college nor be administered by the officials of the college. In most instances, the income designated to a specific college will merely be designated to another college or similar organization in the event of dissolution of the college.

"*Question*: Should the individual college's share of the corpus of the trust be shown as an endowment fund asset on the college's books? In the event you answer the above question 'yes,' please also consider the following:

"My experience with this type trust has been that they are usually established with capital stock from closely-held family-type corporations where all or a large majority of the capital stock is owned by a family and/or a few of the key employees; therefore, there are no sales of stock to establish a fair value. These stocks also are not usually listed, and, therefore, there are no market quotations available. Book value of the stocks as reflected by the books or audit reports of the corporation is questionable as a valuation basis due to hidden assets and various other circumstances.

"*Question*: What value would be most practical to be used in evaluating the share of the trust corpus in the endowment fund assets on the college books?

"*Question*: Under the circumstances, would you attempt to adjust the valuation of the endowment fund assets of the college each year at the annual audit?"

Our Opinion

In your letter you state that "The corpus of the trust will never become the property of the college nor be administered by the officials of the college." You then ask: "Should the individual college's share of the corpus of the trust be shown as an endowment fund asset on the college's books?"

In our opinion, if your first statement is accurate as a legal fact, then it is erroneous to refer to the "college's share of the corpus of the trust." Only if the college had a vested remainder in the corpus of the trust would we consider it proper to record such future property interest as an asset of the college. If the college had a contingent remainder in the corpus, such contingent asset may be disclosed in a footnote to the financial statements.

Either in setting up a vested remainder as an asset or in disclosing a contingent remainder in a footnote (assuming the facts warranted it), it seems to us the already difficult problem of arriving at a fair value for the closely-held shares would be compounded by the necessity of computing the "present value" thereof, i.e., the value today of the property to be received in the future.

Inquiry **541**

College or university plant fund — assets in hands of trustee for retirement of indebtedness

"I am confronted with a problem concerning the proper presentation of a sinking fund in the preparation of a balance sheet for a client of my office.

"I shall outline the facts and the conflict of ideas between the client and myself in the following paragraphs, and would appreciate any assistance you might be able to give me.

"1. There is a bond issue outstanding at the present time of $547,000. The indenture provides for a bond and interest sinking fund account, payments $18,000 annually. The bonds matured and redeemed up to the present time total $33,000. Annual sinking fund payments are approximately $10,000 in excess of bonds maturing each year. Consequently, the sinking fund in the hands of the Trustee at the present time approximates $70,000. These funds may be used by the Trustee to pay interest on, and principal of, the bonds as and when they mature otherwise than by call for redemption. The client has no right, title, or interest in these funds, and they are under the complete control of the Trustee.

"2. I have presented the sinking fund held by the Trustee by the following footnote:

> There has been paid into the sinking fund with the Trustee as of (date) an additional $70,000 for the retirement of bonds. $67,000 is invested in United States Treasury Bonds and Bills. The balance is held in the cash account.

"3. The client insists that the investments and cash should be shown as an asset in the balance sheet and the entire balance of $70,000 credited to the surplus account.

"4. In view of the fact that the client has paid the funds to the Trustee who has complete control over them, I do not feel that they can properly be considered as assets of the client and used to increase the net worth reflected in the balance sheet.

"I will greatly appreciate any assistance you are able to give me on this matter, and feel free to make any suggestions concerning the proper disclosure to be made in the balance sheet."

Our Opinion

In discussing the problem outlined in your letter with another member of the Institute's staff, we learned that he had had a telephone conversation with you regarding the same problem, and on the basis of his discussion with you, he had gained the impression that we should consider your problem within the context or framework of College and University (plant) fund accounting, although your letter does not pose its questions within this frame of reference. We shall assume then, that the problem is essentially how to account for annual payments made to a trusteed sinking fund when the amount of such annual payments exceeds the principal amount of maturing bonds and how to reflect such transactions properly in a plant fund balance sheet (or plant fund section of a balance sheet).

As a basis for discussing your problem, we refer you to "Form 1 – Balance Sheet" in *College and University Business Administration* (American Council on Education, Washington, D.C., 1952, vol. 1, at pp. 48-51), the "Plant Funds" section of which appears as follows:

FORM 1 – *Continued*

BALANCE SHEET

June 30, 19–

ASSETS – *Continued*

V. PLANT FUNDS:			
A. *Unexpended plant funds* –			
Cash	$ 128,500		
Investments (Form 26)	350,000		
Total unexpended plant funds		$ 478,500	
B. *Retirement of indebtedness funds*–			
Cash	5,000		
Investments (Form 26)	185,000		
Total retirement of indebtedness funds		190,000	
C. *Invested in plant* –			
Land	250,000		
Improvements other than buildings	850,000		
Buildings	5,165,000		
Equipment	1,410,000		
Total	7,675,000		
Less endowment funds invested in plant	–220,000		
Total invested in plant		7,455,000	
Total plant funds			$8,123,500

INQUIRY: 541

FORM 1 — *Continued*
BALANCE SHEET
June 30, 19—

LIABILITIES — *Continued*

V. PLANT FUNDS:			
A. *Unexpended plant funds* —			
Accounts payable		$ 23,500	
Notes payable		100,000	
Due to Current General Funds		5,000	
Unexpended Plant Funds balances (Form 8) —			
Plant additions	$ 130,000		
Renewals and replacements	220,000		
Total balances		350,000	
Total unexpended plant funds		478,500	
B. *Retirement of indebtedness funds*—			
Funds balances (Form 9)		190,000	
C. *Invested in plant* —			
Bonds payable		800,000	
Notes payable		150,000	
Net investment in plant			
From gifts	975,000		
From current funds	325,000		
From governmental appropriations	5,205,000		
Total net investment in plant (Form 10)		6,505,000	
Total invested in plant		7,455,000	
Total plant funds			$8,123,500

Note particularly section V. B., under Assets, and sections V. B., and C. under Liabilities. Visualizing the transaction described in your letter in terms of this balance sheet, we believe you might have under section V. B., two accounts designated as follows:

"*Retirement of indebtedness funds in hands of trustee*:

Cash
Investments"

When a cash payment is made to the trustee, we believe the cash would then be reclassified under "Retirement of indebtedness funds in hands of trustee — cash." Upon notification by the trustee of the retirement of $XX principal amount of bonds, the account "Retirement of indebtedness funds in hands of trustee — cash" should be credited in this amount, and, on the liability side of the balance sheet, under section V. B, *Retirement of indebtedness funds,* the account "Funds balances" should be debited. At the same time a transfer in identical amount should be made in section C., *Invested in plant* from "Bonds payable" to the surplus or equity account "Net investment in plant."

Your letter indicates that you have eliminated payments made to the trustee in their entirety from the balance sheet, but we cannot determine what account or accounts were correspondingly debited. Since the client contends that the excess of payments to trustee over the amount actually used for retirement of principal should be restored to surplus, perhaps it is reasonable for us to assume that the effect of the entries made was to reduce surplus, directly or indirectly, to the extent of the excess. We have some reservations about your statement that "the client has no right, title, or interest in these funds." According to our view of the matter, the balance of assets in the hands of the trustee (representing the excess of payments *to* the trustee over principal amount of bonds actually retired *by* the trustee), should be given asset status inasmuch as we believe the fund has an equitable or beneficial interest in the monies and/or securities turned over to the trustee even though legal title is vested in the latter.

Inquiry **542**

Accounting for endowment funds; general rule of inviolability of principal contributions

"One of my accounts is an independent Country Day School for Boys. It is a corporation, has been in operation for nearly one hundred years. Income, if any, in excess of expenditures has always been used for betterments. Recently, the school completed some new buildings at a cost in excess of $2.5 million, all of which has been paid in full by donations from foundations and other interested parties.

"My problem is simply this: The school is now in the process of creating an Endowment Fund, income to be currently transferred to and used for General School Operations. There appears to be a difference of opinion between myself and some of the Trustees as to correct procedure in handling this fund.

"I have segregated the Endowment Fund receipts from General School Funds, and accordingly, opened up a separate set of books. It is my understanding that contributions made to the Endowment Fund of an educational institution should be definitely classified as non-expendable unless otherwise stated by the donor.

"Some of the Trustees feel we could use Endowment Fund Donations and add General School Cash Replacement Funds for the purchase of certain securities. Then we have the feeling among other Trustees that they could invade Endowment Fund Principal when and if needed for current school operations.

"The question also came up, since I insisted upon complete segregation of the Endowment Fund, as to just what would happen to this fund if operations of the school were to be discontinued."

Our Opinion

The most authoritative references of which we are aware, dealing with accounting for endowment funds are:

1. *College and University Business Administration* (American Council on Education, Washington, D.C., 1952) vol. 1, at pp. 91-5 and 139.
2. "Fund Accounting as It Applies to Colleges and Universities," by E. L. Washburn (in the March, 1948 issue of *The N.Y. CPA* at pp. 200-07).
3. "Some Observations on Accounting for College and University Endowment Funds," by R. S. Johns (in AICPA's *How to Improve Accounting and Tax Service to American Business*, 1950, at pp. 157-63).

Note especially the definition of endowment funds set forth at p. 139 of the first-listed reference:

"Funds, the principal of which must be maintained inviolate to conform with restrictions placed thereon by the donor or other outside agency. Generally only the income may be used, but it is recognized that the donor or other outside agency may, by the terms of the instrument of gift, provide for release from the inviolability of endowment funds by permitting all or part to be expended at some future date."

We believe the materials referred to above clearly support your contention that contributions to an endowment fund should be classified as non-expendable unless otherwise stated by the donor. Thus, the endowment fund principal ordinarily may not be invaded for current school operations.

Endowment funds may be invested separately or may be merged for investment purposes in a common investment pool, the pooled income on these investments being distributed to each contributing fund on an equitable basis. Certainly in your case the Endowment Fund Donations can be used for investment purposes for the purchase of certain securities, and if there is no restriction on the similar use of General School Cash Replacement Funds, then for investment purposes these funds can be pooled. R. S. Johns, in his article (*op. cit.*) discusses at pp. 157-8 the accounting treatment to be followed where an institution commingles in its investment pool expendable and non-expendable funds; which may very well be the situation you had in mind.

The question you raise as to disposition of the endowment funds where school operations are discontinued is basically a legal question, the answer to which it seems to us would depend on the laws and judicial decisions of the state where the school is located. This type of situation might well raise the question of whether the funds escheat to the state. Other questions which might arise would be (a) the possibility of a reversion of funds to the donors (or their appointees) in accordance with express provisions contained in the instrument of gift or endowment, or (b) possibility of the application of the cy pres doctrine (where, failing fulfillment of the original objective, the court adapts the charitable donation "as nearly as possible" so as to give approximate effect to the donor's intention).

INQUIRY: **542**

Inquiry **543**

Amortization of premiums or accumulation of discount on bonds purchased for investment

"For some years, the University of .... has followed the practice of systematic amortization of bond premium or discount arising from investment transactions. Roughly, amortization is recorded over the life of the bond concurrently with each interest receipt (generally interest is not accrued).

"If bonds are disposed of prior to maturity, the difference between the proceeds and amortized cost is treated as gain or loss on sale.

"Since we have a rather large investment portfolio (about $48 million in bonds at June 30, 1959) with numerous transactions, considerable effort is required to perform this systematic amortization. In view of this, the question has been raised as to whether such amortization is necessary to conform with generally accepted accounting principles.

"For background information, I would like to indicate that our financial statements are prepared in accordance with the balanced-fund principle of accounting and on an accrual basis except gifts, grants and endowment fund revenue (interest and dividends) are not recorded until received. These statements are certified as being in accordance with generally accepted accounting principles.

"The major portion of our investments are 'held' by two funds, the Endowment Fund which reflects gifts and grants, the income of which may be expended but the principal of which must be maintained intact; and the Employees' Retirement Fund which reflects retirement funds managed by the University but in which the University has no direct interest.

"Bond interest income on investments of the Endowment Fund adjusted for amortization is reflected as an element of revenue in the University's 'Statement of Revenue and Expenses.' Adjusted interest on investments of the Employees' Retirement Fund is not reflected in the statement of revenue but is shown as one of the elements of change in the fund balance as are employee and employer contributions.

"Based on the above, there appears to be little purpose served in amortizing premium or discount on investments of the Employees' Retirement Fund. Such a change would have no effect on the revenue statement of the University. Although the balance sheet of the Fund would be affected, it would probably not be material, and if it were material, might still be unimportant since the cost of securities (amortized or not) is of a historical nature and serves little value for determining adequacy of reserves for retirement benefits.

"The Endowment Fund does of course present different problems. There is the effect on the revenue statement as well as the need to distinguish between income and principal. If unamortized bonds are held to maturity and redeemed at face value, premium or discount could be written off as a lump-sum against interest in the year of redemption. If bonds are sold prior to maturity, some question might arise as to whether the difference between proceeds and cost affects income, principal, or both.

"In an article written several years ago by a member of a national public accounting firm the following statements were made:

> Premiums on bonds purchased with endowment funds should be amortized in order that endowment principal may be kept intact.
>
> It does not necessarily follow that discounts should be accumulated when bonds are purchased below par. The purpose of amortizing premiums is to protect the principal of the funds. To accumulate discounts may defeat this purpose. While, as between income and principal, the rights of income should be recognized along with the rights of principal, it is doubtful whether income should be enhanced currently by the process of accumulating discounts (transferring principal cash to income cash). Inasmuch as the very fact that the bond may be purchased at a discount may be an indication that it may not be paid in full at maturity, if any recognition of the principle of accumulating discounts is to be made, it should be deferred until the collection in cash of the face amount of the bond has been effected, presumably at maturity. To do otherwise might result in an unwarranted enhancement of income at the expense of principal.

"I have some question on the above statement as I believe bond purchases at a discount (by universities at least) are made to adjust interest rates and not because of any doubt about full payment at maturity.

"I would appreciate any comments you may have or any appropriate references covering this topic."

Our Opinion

None of the Institute's Accounting Research Bulletins discuss amortization of premiums or accumulation of discount on bonds purchased for investment purposes. However, if frequency of employment of a practice is to be given weight, we believe the following succinct excerpt from *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957, at p. 439) is relevant to your question "whether such amortization is necessary to conform with generally accepted accounting principles," viz.:

> ... When investments include a substantial amount of bonds purchased at a premium, the premium is frequently amortized over the period to the earliest call date or maturity. Discount on bonds may be similarly amortized, but this practice is less frequent. Discount on speculative bonds should not be amortized when its eventual realization is uncertain.

Also, the last four paragraphs on p. 13.6 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956) contain some comments which may be helpful in concluding whether a specific treatment or lack of treatment is "generally accepted." It goes without saying a treatment may be *tolerable* since it involves relatively immaterial amounts in the particular circumstances, but this does not make such treatment *acceptable* in principle albeit an unqualified opinion on the statements may be rendered.

Personally, we are inclined to agree with your conclusion that amortization of premium or discount on investments of the Employees' Retirement Fund may be discontinued without any drastic effect on the "fair presentation" or over-all representations in the financial statements.

On the other hand, we would be reluctant to abandon the practice of amortizing premium and discount on bonds held by the Endowment Fund primarily because of the need accurately to distinguish between principal and income and because the financial statements purport to be substantially on the accrual basis.

If the practice of periodically amortizing and accumulating premium and discount *is* to be discontinued, then when bonds are sold prior to maturity, the cost thereof may be adjusted retroactively for amortization or accumulation accruable in the past (with a correlative lump-sum adjustment to interest income) before determining gain or loss to principal. In any event, before reaching a decision as to whether amortization and/or accumulation is to be discontinued, an estimate of the annual net adjustment to book value of securities as a percentage of the aggregate book value of assets involved and of income collected, should be made for the purpose of deciding on materiality of effect.

We also have reason to question the soundness of the conclusions expressed in the passage quoted toward the end of your letter. Non-recognition or deferral of recognition of accumulated discount is acceptable, in our opinion, only in cases where speculative or low-grade bonds are involved or where the effect of such non-recognition or deferral upon the statements is de minimis. The policy recommended in the quotation tends to discriminate against current activities, projects, or functions. In endorsing amortization of premium but non-accumulation of discount it does not state a philosophy that "half an accrual is better than none," but rather that "partial accrual is better than complete accrual."

MISCELLANEOUS NON-PROFIT ORGANIZATION PROBLEMS

Inquiry 544

Should amortizations of bond premium and discount, and accrued interest receivable, be reflected on books of employees' pension fund?

"I am an administrator of a large pension plan which arises out of collective-bargaining agreements. The annual income is between the sum of $1.5 million and $2 million.

"I would like a few points on the following subjects, as to how to account for them:

1. *Bond Discount or Premium Amortization* — It has been called to my attention by our actuaries, and by the corporate trustees, that they no longer amortize the bond premium or discount.
2. *Accrued Interest Receivable* — Here again the actuaries and the corporate trustees do not set up accrued interest receivable.

"Since all the books of the company clearly reflect the setting up of accrued interest and the amortization of bond premium and discount, I would appreciate your comments on the proper practices that are employed within pension funds."

Our Opinion

The Institute has never undertaken a direct survey of health and welfare and pension funds to determine what majority practice is regarding the accounting treatment of accrued interest receivable and bond premium and discount amortization.

However, we note that the July 31, 1958 statement of net assets of the Retirement System for Employees of R. H. Macy & Co., Inc., contains an item "Income receivable" which we presume reflects interest or dividends receivable; and although it constitutes less than 1 per cent of the total assets, nevertheless it was set up as a receivable.

Also, in the Institute's *Case Study on Audit of a Self-Administered Union-Industry Welfare Fund* (1959), we note that the balance sheet contains under "Receivables," an item entitled "Accrued interest on investment bonds." Furthermore, the case study includes a balance-sheet footnote to the effect that investment bonds are shown at cost adjusted for amortization of premiums and discounts.

The publication *Accounting Principles for Health and Welfare Funds,* prepared by the Los Angeles Chapter Committee on H. & W. Funds, makes no specific reference to the treatment of accrued interest and bond premium and discount. However, you will note the recommendation that the accounts should be placed on the accrual basis for statement purposes.

On the other hand, in an article in *The N.Y. CPA* (February, 1958) entitled "Union Welfare Funds," R. Buchbinder states at p. 107 the following:

> It is advisable that the auditor's report be prepared on a cash basis. The trustees prefer this basis as it enables them to discern the cash flow more readily and to determine the liquid funds available for future expenditures. The cash basis can properly reflect the condition of a welfare fund; if the total of the contributions which are received currently, exceed the total of the cost of

> benefits, administrative expenses and reserve requirements, then there will be sufficient cash available to pay all bills upon receipt. Consequently, the unpaid liabilities at the end of the accounting period would not be of a material amount. This basis also lends itself to the preparation of the annual statement required by the State of New York. Of course, if the above conditions do not exist, the accrual basis may be used.

We note further that the latest report of *The United Mine Workers of America Welfare and Retirement Fund* is prepared on a cash receipts and disbursements basis.

It appears that some trustees, for convenience or for practical considerations, employ the cash-basis method of reporting, although it is recognized that the accrual basis of reporting is the only completely proper method of matching income and expense.

In any event, we believe trustees and fund administrators should consider the practical aspects of balancing any cost-savings obtained by elimination of annual adjustments for premium and discount against the added refinement that use of the accrual basis of reporting would give to the financial statements, in order to determine whether accrual of the items in question is worth the effort (giving, of course, due regard to materiality of amounts involved.)[1]

Incidentally, the question of setting up an accrual for interest receivable arises in accounting for finance companies. It is of some interest to note that, in answering an inquiry some time ago as to whether the majority of finance companies disregard setting up accrued interest receivable and payable at the balance-sheet date, we stated as follows:

> As far as we can determine, *no one method* of treating interest earned but uncollected at balance-sheet date may be said to be *the* generally accepted method in the small loan business. It does seem to us, however, that the accrual basis, in the absence of extraordinary conditions, is always an acceptable basis, while the cash basis should be regarded as the exception (*our emphasis*)....If we were to make an "educated guess," we believe that perhaps the majority of the companies holding interest-bearing notes do not accrue interest earned but uncollected at balance-sheet date possibly on the ground that the amount involved is immaterial in relation to total income.

[1] In this connection, see W. F. Lackman's article "Streamlining Administration and Operation" (in the March, 1956 issue of *Trusts and Estates*, p. 232).

Inquiry 545

Regarding the carrying value of securities held by institutions for long-term investment

"As the matter is not covered in any of the official pronouncements of the American Institute of Certified Public Accountants, would you please advise as to the values at which securities held for long-term investment by institutional investors such as life insurance companies, *other than for control* purposes, should be carried in the balance sheet of such institutions?"

Our Initial Opinion

In our opinion, securities held for long-term investment, whether by commercial or institutional investors, should be carried on the balance sheet at cost with market value indicated parenthetically. However, where market value is less than cost and it is evident that the decline in market value is not due to a mere temporary condition, the cost of the securities should be written down to, and carried at, market value. All bonds if purchased at a price other than face value should as a general rule, be stated at their amortized values.

Of course, life insurance companies are subject to the various state regulatory laws. In general, the law and regulations require that bonds be stated at "amortized values" or "fair market values" and that stock be stated at the values prescribed by the National Association of Insurance Commissioners (i.e., at the so-called "Association Values" as published), or optionally at current year-end market values.[1]

[1] For authoritative discussion of some general principles governing the recording and statement presentation of both marketable securities and investment securities, see *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at pp. 145-6, 157-60, and 304. For an informative and critical discussion of valuations used in life insurance company financial statements, especially pertaining to bonds and stocks, see the chapter entitled "Valuation of Assets" at pp. 497-541 of *Life Insurance Statements and Accounts*, by E. C. Wightman (Life Office Management Association, New York, 1952).

Follow-Up Inquiry from Same Correspondent

"Thank you very much for your informative letter. I would like to pose a few additional questions in relation to statements made in your letter. These questions are asked relating to the valuation of diversified portfolios of securities held by life insurance companies as long-term investments ignoring present statutory law for the valuation of securities for such companies.

"Would you change your opinion on the statement 'However, where market value is less than cost and it is evident that the decline in market value is not due to a mere temporary condition, the cost of the securities should be written down to, and carried at, market value' if conservative investment loss reserves were held against a diversified portfolio of securities? One of the major problems we are facing on our project is the size and purpose of such investment loss reserves so the question posed is of considerable interest and importance to us.

"Should low-grade bonds, not in default, 'if purchased at a price other than face value . . . be stated at their amortized values'? Should defaulted bonds 'if purchased at a price other than face value . . . be stated at their amortized values'? Would your answer to either of the above two questions be changed if conservative investment loss reserves were held against the bond portfolio?"

Our Further Opinion

In general, where the market value of securities held as long-term investments has declined materially in price since date of acquisition and over a long period of time, in our opinion, support may be found for all three of the following alternative treatments: (a) reflect the extent of the decline parenthetically in the balance sheet, (b) write the cost of the securities down to market value, or (c) establish an allowance to reflect the decline.

We believe the following excerpt from Johnson's *Auditing: Principles and Case Problems* (Rinehart & Co., N.Y., 1959, at pp. 158-9) is a sound answer to the questions you now raise:

> If the valuation of a long-term investment has declined significantly and the deterioration in value appears to be permanent, i.e., capital will assuredly be lost in the collection process, the creation of a valuation reserve out of the current Profit and Loss would be in order. This would be the case, for example, for de-

faulted bonds or for bonds giving strong evidence of going into default.

For an extended discussion of the treatment of defaulted bonds on the books of the holder, see pp. 164-9 of Paton and Paton's *Asset Accounting* (Macmillan Co., N.Y., 1952). Paton states at p. 145:

> ... where long-term bonds are acquired on the market at substantially less than maturity value because of serious danger of default the accruing of the difference between the price paid and maturity value, period by period, on the basis of a computed yield rate, is questionable procedure.

Finney and Miller state at p. 306 of their *Principles of Accounting – Intermediate* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1958):

> If bonds are purchased at a considerable discount because the issuing company is in a weak financial condition, the collection of par at maturity may be doubtful and the accumulation of the discount may therefore be unjustified.

We agree with the foregoing conclusion. Thus, the statement in our previous letter (which, however, was based on the assumption that you were dealing with "institutional investors such as life insurance companies" who ordinarily would not be investing in either low-grade bonds or defaulted bonds), viz., "All bonds if purchased at a price other than face value should be stated at their amortized values," is too categorical and is subject to qualification. Doubtless this statement should be confined in its application to the case of "bonds with a high rating" (see Paton, *op. cit. supra,* middle of p. 146) and the cost approach (as described in Paton, *op. cit.*, p. 145) should be used in the case of bonds selling at a price substantially below their maturity value.

This matter of the use of investment loss reserves, it seems to us, raises a question concerning the propriety of creating the reserve out of surplus. Our personal opinion is that provisions for such reserves and subsequent adjustments to increase or diminish such reserves (except the portion of the cost of an investment directly written off thereagainst) should generally be charged or credited to the profit and loss account. However, merely as a matter of interest or information, we note that the *NABAC Manual – Bank Accounting, Auditing, and Operation* (National Association of Bank Auditors and

Comptrollers, Chicago, 1951, p. 65) provides for the following two reserve accounts:

> Reserve for Losses — A transfer of invested capital to apply to the reduction of the loan account or securities account, because of possible losses due to a credit nature.
>
> Reserve for Market Fluctuations — A transfer of invested capital for the reduction of a securities account, in order to give a true portrayal of market values for balance sheet or statement purposes.

The use of investment loss reserves also inevitably raises a question as to the propriety of restoring a portion of a writedown previously made upon subsequent recovery of the market price.[2] In this connection, see the exchange of correspondence *directly following*.

Inquiry 546

Use of valuation reserve procedure in recognizing decline in market value of non-profit organization's permanent investments

"Advice is requested with respect to the following questions:

"1. If recognition is given to a substantial decline in the market value of permanent investments by a non-profit organization (not an individual's participating trust) and the loss is brought through the current income statement, may future years' market value recovery (by appreciation — not by sale or exchange) be brought through the then current income statement?

"2. If not, does the earlier recognition of the decline in market value presuppose the adoption of a new basis for the permanent investments with its corresponding non-anticipation of income principle?

[2] For two additionally helpful references, see:

1. Holmes' *Auditing Principles and Procedure* (R. D. Irwin, Inc., Homewood, Ill., 1959) p. 454.
2. *Montgomery's Auditing* (Ronald Press Co., N.Y., 1957) at middle of p. 147.

"3. Would the broad treatment (showing historical cost less an evaluation allowance for market decline) on the balance sheet under a non-current caption be preferred over a net value presentation?

"4. As independent Certified Public Accountants engaged to audit the balance sheet of an industry's welfare fund, the auditors request that a contingency reserve be created by a segregation of the unassigned fund balance. This contingency reserve is in the amount of $200,000 which is equal to a market decline of 10 per cent of the cost of permanent investments. The auditors further request that a journal entry be placed on the fund's books reflecting the balance-sheet presentation. The trustees of the fund, acting upon the advice of their attorneys, refuse to recognize these requests of the auditors, and insist upon only a parenthetical balance-sheet expression of market value.

"What effect would the above have on the opinion of the auditors?

a. Would a qualification be necessary?
b. Would merely a parenthetical expression as to market value (substantially lower) suffice so as to come within the scope of a fair presentation?
c. Could an unqualified opinion be rendered?

"5. If the decline in the market value of permanent investments set forth in number four (4) above has persisted for three years with no apparent evidence for current recovery, would the request of the auditors to segregate the unassigned fund balance be sufficient? Should a more positive request be made to bring the decline through the current income statement?"

Our Opinion

Regarding your first and second questions, none of the Institute's official bulletins or statements provide a definitive answer. However, see par. 9 and the first dissent at p. 23 of *Accounting Research Bulletin No. 43* (AICPA, 1953). Essentially, you are asking whether, once a loss is recognized or a portion of an asset's cost is written off *deliberately,* such entry or transaction is later properly subject to reversal, correction, or a "re-accounting." Relevant to this question, it is of some interest to note that *Accounting Research Bulletin No. 27, Emergency Facilities* (now superseded by chapter 9C of *A.R.B.*

No. 43) approved the reinstatement or restoration of asset values already written off, i.e., the adjustment or restatement of accumulated amortization or depreciation previously recorded with respect to emergency facilities. On the other hand, chapter 4 of *Accounting Research Bulletin No. 43,* which deals with "Inventory Pricing" states in a footnote on p. 28 that "In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes." In this connection, we note that where a "Valuation Reserve Procedure" is used to adjust inventories from replacement cost to a lower market, the *recovery* of a previously recognized market decline is generally reflected in the income statement as an adjustment of cost of sales or as a special income credit. [See *Accountants' Handbook* (Ronald Press Co., N.Y. 1956) at pp. 12.47-8.]

If the American Accounting Association's *Supplementary Statement No. 5, Accounting Corrections* is taken as authority for the purpose of resolving your first two questions, it appears that the initial writeoff for substantial decline in market value may be reversed and value restored to the extent that there is a recovery of market value to original cost. In other words, if the initial judgment that a permanent impairment in investment value has taken place and that consequently a loss should be recognized, is proved erroneous by subsequent events, the AAA Statement now holds (although it did not so hold formerly) that "correction of judgment errors . . . is proper."

Regarding the reference in your second question to the "non-anticipation of income principle," query whether correction of an original writedown of investment value to the extent of the market price recovery of such writedown, may better be viewed as a restoration of an unrealized loss rather than as an anticipation of income or recognition of unrealized appreciation?

We are not aware of any official recommendations on your third question. The two presentations which you mention are definite possibilities; other alternatives would be to show cost with market parenthetically, or market with cost parenthetically. Personally, we feel that if the basic accounting policy to be followed is one whereby recognized declines are deemed to result in a new cost for all subsequent accounting purposes, then the recognition of the decline may be effected by a direct credit to the investment account and the investment subsequently be reflected in the balance sheet at the "new cost." On the other hand, if the basic accounting policy is one whereby corrections are to be made for subsequent recoveries of recognized declines, then we feel the decline may best be recognized in the first instance by means of a valuation reserve or allowance account, and subsequent recoveries may be recorded by adjusting the reserve (similar to the "Valuation Reserve Procedure" used for inventories).

If a "Valuation Reserve Procedure" is to be used in connection with investments, it seems to us a basic accounting policy decision must be made, viz., *whether* the reserve is to be a "reserve for market price fluctuations" which would periodically, i.e., regularly, be adjusted to measure the difference between cost and a lower market *or* whether the reserve would be established at the time of making a "one-shot" adjustment to record what was deemed a permanent impairment in investment values and would be increased or decreased at irregular intervals in the future only to reflect further market value decline or complete recovery to original cost.

Regarding your questions numbered "4" and "5" – although the auditors' suggestion that a contingency reserve be created by a segregation of the unassigned fund balance may be advisable and laudable, nevertheless, it is our opinion that surplus or fund balance segregations or appropriations not dictated by legal requirements are matters primarily within the discretion of management or the board of directors or trustees. We do not feel that a refusal to segregate the unassigned fund balance requires a qualification as to fair presentation *provided* that there is a parenthetical balance-sheet expression of market value.

If, on the other hand, a material decline in investment values has persisted for three years with no apparent evidence for current recovery, then the auditors should insist on a writedown for permanent impairment in value, and if the client refuses to recognize the decline, they should qualify their opinion if thoroughly convinced of such impairment. Unfortunately, there are no easy rule-of-thumb criteria or indicators of permanent impairment in value.

Inquiry 547

Merging the financial presentation of building fund and plant fund — old age home

"I am the controller of an old age home having a fund accounting setup. We have a General Fund, a Building Fund, and a Plant Fund. All routine transactions are handled through our General Fund. On the other hand, all the fund-raising efforts, and the disbursements of such funds for the purpose of construction and other capital improvements, are recorded in our Building Fund. The Plant Fund, on the other hand, reflects all the capital expenditures incurred either by the Building Fund or by the General Fund. Very recently, I have been requested by Board members that the balance sheet of the Building Fund include the assets of the Plant Fund so as to permit the reader of the balance sheet of the Building Fund to see the extent to which funds raised by the Building Fund have been applied to construction and capital improvements. Upon my protest that such inclusion of plant assets in the Building Fund would represent a duplication of our Plant Fund and therefore be misleading, I was requested to show the plant assets as an asset of the Building Fund and to set off against such asset a reserve for the same amount.

"I feel that this is an improper approach and to a certain extent reduces the significance of the Plant Fund. May I have your opinion?"

Our Opinion

We assume that the Building Fund mentioned in your letter is a self-balancing group of accounts reflecting the acquisition of cash, and possibly other assets, as a result of a drive or campaign to raise funds for the construction or acquisition of fixed assets.

First, we would call your attention to the definition of "plant funds" and to the balance sheet of a hospital appearing in the *Accountants' Handbook* (R. Wixon, ed., Ronald Press Co., 1956, N.Y., pp. 25.70 and 25.73). See also the balance sheet of a hospital shown in *Handbook on Accounting, Statistics and Business Office Procedures for Hospitals* (published by American Hospital Association, Chicago, 1950, pp. 68-9). You will note that the balance sheet in the *Accountants' Handbook* shows a subgrouping of "Plant Funds" entitled "Unexpended

Plant Funds" which reflects assets in the form of cash and investments to be expended for additions to physical plant or for the replacement or renewal of existing plant. Similarly, the other balance sheet shows a subgrouping of "Plant Funds" entitled "Improvement and Replacement Fund" also reflecting cash and investments. We believe both of these subgroupings may be comparable in function to the Building Fund maintained by your institution.

In our opinion, showing funds earmarked for the acquisition of fixed assets, funds applied to construction-in-process, and funds invested in plant facilities in use, together with liabilities, liens and encumbrances, thereagainst, and the equity of the institution in these assets, makes for a useful, over-all presentation.

Accordingly, we believe you should give consideration to the merging of your Plant Fund and Building Fund in one over-all presentation. This, of course, would involve no duplication of assets in any respect, and it seems to us that this manner of presentation would enhance, rather than reduce, the significance of the Plant Fund.

Inquiry **548**

Concerning the need for a municipality's maintaining its utility and general funds separately

"We are involved in a dispute with a local attorney in connection with the need for maintaining a water fund separate from the general fund in a municipality.

"One side contends that since revenue from water charges is not being used for any specific purpose and since there is no outstanding indebtedness, all water fund transactions should be handled through the general fund and the water fund should be eliminated as a separate fund.

"The other side contends that you cannot combine a utility fund with the general fund, however, you may budget utility fund 'profits' to help the general fund operations."

Our Opinion

It appears that the question is not so much whether a utility fund can be combined with a general fund as it is whether the funds *may* or *should* be combined when considered from a number of standpoints, viz., from legal, separate accountability, customary practice, comparability, consistency, managerial, and future-growth-and-need, standpoints. We believe it would be the exception rather than the rule if the accounts of the utility fund were to be merged with, or submerged in, the general fund.

A look at *Municipal Accounting and Auditing* (Natl. Comm. on Govt. Acctg., MFOA, Chicago, 1951) may help in some measure to resolve the difficulty. You will note that this publication frankly recognizes that a multiplicity of funds may introduce an element of inflexibility into the financial administration and budgeting, and therefore urges that "only those types of funds . . . should be used by a particular municipality which are called for either by legal provisions or by the principles of sound financial administration." (*op. cit.*, p. 5). The publication, of course, recognizes "Utility or Other Enterprise Funds" as one of the customary fund classifications. The following statement (at p. 4) would seem to favor separate maintenance of a utility fund, viz.:

> Sometimes, too, funds are created for purposes of financial administration only; for example, because a utility is presumed to be a self-supported enterprise, its finances should be accounted for in a separate fund, even if not required by law.

Inquiry **549**

Merging of current and plant fund; effect on report

"We have a client which is an incorporated non-profit institution.

"For purposes of simplifying the accounting procedures at the time machine accounting was installed, the business manager, who is a CPA, combined the Current and Plant Fund accounts so that it is necessary for us to present these funds on a combined basis in the statements, setting forth the change in the accountants' report letter.

"May we have your opinion as to whether the departure from the customary presentation of separate Current Fund and Plant Fund accounts constitutes an exception which would affect the report opinion? (There are no restricted assets in the Plant Fund.)"

Our Opinion

In our opinion, no exception need be taken in the opinion paragraph of your report since the merging of the Current Fund and Plant Fund accounts involves essentially a change in mode of presentation or classification of accounts, and as we view it, does not constitute an inconsistency in the application of accounting principles as such. We agree with you that the change in form or manner of presentation should be succinctly set forth in the accountants' report letter as a necessary explanation.

We feel that explanation is necessary since *formal* comparability of financial statements with those for prior years has been affected. However, we have always deemed a change in accounting principle or practice to be one primarily involving the method of accumulating or estimating the *amounts* under a specific account heading or headings, thereby affecting comparability of current and prior years' accounts in a much more substantial way.

Inquiry **550**

Non-profit home for aged — transfer of securities between funds

"Our client, a non-profit home for the aged, has within its system four fund accounts through which they control the financing of the home. These funds are an Endowment Fund, Reserve Fund, A.B.C. Fund, and an Operating Fund. The first three are made up of cash and securities in the form of stocks, bonds and treasury notes. The

Endowment Fund is restricted in that it cannot transfer cash in excess of the amount of income it receives from the securities held within the fund. The cash restriction does not apply if cash is used to purchase other securities.

"The home is at present in the midst of constructing a new building and the cash requirements have made necessary, transactions between funds. During the course of the 'sale' of securities from the Reserve Fund to both the Endowment Fund and the A.B.C. Fund, the amount charged by the trustee of the funds was the market value at the date of the sale rather than the original cost of the stock. Thus, in the last two months there has been an inter-fund 'profit' on the sale of securities in the amount of $29,036.88. This method has made available to the Reserve Fund a greater amount of cash which it could transfer to the Operating Fund for the requirements of the building in process.

"We do not believe the transactions between funds should be regarded as inter-fund sales but they should be regarded as transfers from one fund to the other. Therefore, we do not think that an inter-fund profit on the sale of securities should be recognized, nor should the corresponding carrying of securities at the market value on the balance sheet be allowable. We contend that transactions between funds in which stock is involved should be on the basis of cost, and any difference between cost and the higher market value would be a mere transfer of cash. In this way, no inter-fund profit would be recognized, and the securities would be stated at cost in the balance sheet.

"We would appreciate an opinion from you as to whether such transactions from within an organization should be considered as arm's-length sales in which profit should be recognized or should they be considered as transfers at cost with inter-fund profit not recognized?

"The trustees state that commission expense is saved by merely transferring securities from one fund to another instead of actually selling the securities in the market and then immediately purchasing the same."

Our Opinion

It seems to us the answers to the questions raised in your letter depend on (a) whether the funds which have been set up are to be construed as separate legal and accounting entities in accordance with whatever legal prescriptions may be contained in the documents authorizing the creation of these funds, even though they are commonly administered, or (b) whether these funds are merely to be viewed as convenient or useful accounting arrangements which have been adopted to control the financing of the home, or (c) whether some of the funds are to be deemed separate legal and accounting entities in accordance with (a) and some to be deemed merely convenient accounting arrangements in accordance with (b).

Any fund, coming within the purview of (a), that sells its securities to any other fund, in our opinion, should be paid current fair value for any securities transferred, in order to forestall dissipation of the fund principal or corpus, and, by the same token, despite the fact of common administration, any fund acquiring securities and paying current fair value therefor, may properly record such fair value as its actual cost.

We are inclined to favor the view that the several funds involved here come within the purview of (a) above; accordingly, we do not believe these transfers are qualitatively the same type of transaction as, say, interdepartmental transfers in the case of any ordinary commercial establishment.

We fail to see why the Reserve Fund would not *have* to record an increment to its fund balance, if the acquiring funds (Endowment and A.B.C.) paid amounts of cash equivalent to current fair value of the securities transferred, and such fair value was in excess of "cost" or carrying value of the securities on the Reserve Fund's books.

Inquiry **551**

Income and assets transferred between affiliated non-profit organizations by board resolutions

"In connection with the examination of the accounts of one of my clients, certain matters have come under discussion. I would appreciate your comments on the respective situations.

"1. Company A, a non-profit educational organization, keeps its accounts on the accrual basis and prepares semiannual audited financial statements for distribution to its Board of Directors and other interested persons. Company B was subsequently organized and is affiliated with Company A in that it has as its aim the maintenance and furtherance of the program and objectives of Company A. Company B receives donations and other income from Company A and from other outside parties, and invests these funds to obtain income for the use of Company A. The Board of Directors of Company A has resolved that at the end of each fiscal year (December 31) 50 per cent of the net income of Company A should be transferred to Company B to be administered for the use and benefit of Company A. My first question is this: In preparing semiannual financial statements for the first six months of the fiscal year, should the 50 per cent of net income be shown as a current liability on the statement of Company A and as a current asset on the statement of Company B, or should the matter be handled by a footnote to the financial statements of both companies, or is there an alternative suggestion which you would care to propose?

"2. The second question which I have is in respect to the same companies. The Board of Directors of Company A resolved in 1957 to transfer to Company B, the building which is presently owned by Company A and certain securities presently owned by Company A. Title to these assets was actually transferred July 1, 1958. Income from these assets, such as dividends, rent and interest has been transferred to Company B since this resolution was enacted. My second question is in respect to this income earned on the transferable assets: At what point does the income become attributable to Company B – at the time the assets become transferable or at the time the title was actually transferred to Company B?"

Our Opinion

1. Regarding your first question, in our opinion, disclosure of the terms of the board's resolution in the semiannual financial statements of Company A is an acceptable way to handle the matter. Although we believe such disclosure in the semiannual statements of Company A is desirable, we do not think it is required.

On the basis of the information in your letter, we are inclined to construe the board's resolution as a *declaration of policy* as to year-end appropriation of net income for investment purposes, not as an *irrevocable declaration of trust.* At the midyear point, it seems to us Company A has incurred no obligation which would require setting up a liability. The amount, if any, to be transferred pursuant to the resolution can be definitely determined only at the year-end. Therefore, it appears there would be no legal liability to pay over a fixed and determinable amount at midyear even if the board's resolution is considered to have the legal effect of an irrevocable gift or declaration of trust.

Incidentally, the question whether any funds transferred at the year-end should appear in Company A's balance sheet as an investment or advance, or in its statement of operations as a donation, would seem to depend considerably on a legal determination whether the transfer involves merely a change in the custody of the principal funds or an irrevocable entrusting of the principal amount. This determination, of course, would also be highly relevant in deciding whether Company B should reflect a liability to Company A for any principal funds received.

In our opinion, it is optional whether the Company A board resolution in question should be disclosed in the semiannual statements of Company B. It seems to us that disclosure of the resolution would imply a prospective receipt of funds at year-end, the receipt of which is contingent and the amount of which is indeterminable at this time.

2. Regarding your second question, it appears the board by its resolution and by its subsequent actions intended a present gift or assignment of prospective income from the assets. In our opinion, all income earned by the assets prior to the time when Company A actually divests itself of title to the assets, is properly attributable to Company A. Its transfers of the income in question to Company B represent gifts or contribution thereto. After actual transfer of title to the assets, any income earned thereon is properly to be regarded as dividend and rental income, and interest, accruing to Company B. The foregoing view, we believe, follows essentially a well-reasoned and rather famous tax case (cf. Lucas v. Earl). In developing the basic rationale that income is attributable to the owner of the assets or capital which throw off the income, the case resorted to the metaphor that "the fruits (may not be) attributed to a different tree from that on which they grew" – even if the owner never sees or never has the actual use and enjoyment of the fruit.

Inquiry **552**

Reporting on fraternal insurance company's balance sheet where actuarial reserve not calculated as of interim date

"We are in the process of preparing an audit report for a fraternal insurance company covering the transactions for the period January 1 to March 31.

"It will consist principally of a statement of cash receipts and disbursements with a verification of assets and liabilities as of March 31.

"Since the actuary *will not* calculate a reserve for policies outstanding as of March 31, it is our feeling that no attempt should be made to determine surplus as of that date. Therefore, the difference between assets and liabilities will simply be shown as 'Fund Balance' so designated on the financial statements.

"Is our treatment of this problem in accordance with acceptable insurance accounting procedures for interim statements?"

Our Opinion

We believe your contemplated treatment of the problem outlined in your letter would be an acceptable accounting procedure for interim statement purposes, provided that disclosure is made in a footnote or otherwise in your report, of the amount in the reserve for policies outstanding when last calculated actuarially, together with a statement to the effect that inasmuch as the amount at which this reserve should be stated at March 31 is unknown (being calculated actuarially only once a year) and may constitute a material portion of retained earnings at March 31, no attempt has been made to earmark any portion of retained earnings. For this reason, we believe the CPA's report should contain an adverse opinion as to the fairness of presentation of the company's statement of condition. If the fraternal company involved is a corporation, you may want to consider the designation "Total Surplus Including Reserve for Policies Outstanding" as an alternative to the term "Fund Balance."

Inquiry **553**

Union-industry pension fund — should actuarial liability be set up for vested pension rights?

"We have been engaged by a union-industry pension fund which was formed recently and would appreciate your comments on a problem which has arisen in connection with preparation of their financial statements.

"The fund is administered by a joint labor-management board of trustees and is financed by employer contributions for hours worked by covered employees. The pension benefits are self-funded, in that they are not insured with an outside carrier but are paid to the participants directly by the fund. An independent consultant provides the necessary actuarial services.

"The trustees have agreed that the financial statements should be prepared on an accrual basis. If so, the question arises as to whether or not some provision should be made in the statements for the estimated cost of future benefits for those already granted pensions. This amount could only be determined actuarially since retirement benefits are paid in fixed monthly amounts during the lives of the participants.

"The trust agreement under which the fund was created specifies that the trust will terminate:

> In the event the Trust Fund shall be, in the opinion of the Trustees, inadequate to carry out the intent and purpose of this Agreement, or to meet the payments due or to become due under this Agreement to persons already drawing benefits;

In the event of termination, the trustees shall:

> Apply the Trust Fund to pay any and all obligations of the Trust and distribute and apply any remaining surplus in such manner as will, in their opinion, best effectuate the purposes of the Trust.

"If it is considered necessary to reflect the total estimated costs of benefits granted in the financial statements, there would seem to be several alternatives available:

1. Current charges against income
2. Segregation of a portion of the net assets
3. Inclusion in a note to the financial statements."

Our Opinion

Bearing in mind in the case in question the provisions respecting discretionary termination of the trust by the trustees, in our opinion, it would be proper to confine the provision or charge against current operations, to the amount of pension claims accrued, i.e., currently payable as of the balance-sheet date.

We believe it would also be informative and proper *either* to disclose in a footnote to the statements, the actuarially estimated costs of future benefits deemed ultimately payable to those whose pension rights have already vested, *or* to reflect such actuarially computed amount as a segregated surplus reserve, clearly described, i.e., if sufficient surplus is available for earmarking in this manner. It seems to us it would also be helpful to have the independent actuarial consultant calculate, for disclosure in the financial statements, the estimated benefit payments to be made within the forthcoming fiscal year, and further, to have him express an opinion as to whether the present level of contributions is sufficient to maintain the long-term solvency of the fund. Such information, we believe, would be invaluable to the trustees.

Incidentally, for its general relevance, note "Exhibit I. – A Welfare Fund Statement of Assets and Liabilities" in the AICPA *Case Study on Audit of a Self-Administered Union-Industry Welfare Fund* (1959). Note especially the caption "Unassigned funds, reserved for future benefits and administration." This case study situation differs from yours in that the benefits are funded by insurance.

Inquiry **554**

Accounting presentation of charitable foundation's vested remainder in real property subject to intervening life estate

"We have been retained by a charitable foundation to prepare certain financial statements, and we are at a loss to know how to disclose certain assets on the balance sheet. We would appreciate your answering some questions regarding this financial statement.

"1. The foundation has entered into several irrevocable trust agreements by which the foundation becomes a remainderman in certain real property, and the grantor maintains a life estate. Is it permissible to show the fair market value of these properties as an asset on the balance sheet, with an offset among the liabilities for the same amount? If so, how would these assets be labeled on the balance sheet?

"2. The foundation has also entered into irrevocable trust agreements covering certain notes receivable that are being collected by the foundation. How would these notes be labeled on the balance sheet, and what would be the offset in the liability section?

"3. Are we correct in assuming that if we do disclose these assets on the balance sheet it would be proper to have the offset as a liability, or would the offset be a part of the capital? It is our impression that even though the foundation has certain interests in these assets, the offset should be a liability and it would not become a part of the capital until after the grantor passes away.

"What is the capital of a non-profit foundation usually called? For lack of a better name we have used 'fund principal.' We are not sure that this adequately discloses, but you can understand that we would hesitate to show a balance sheet for a non-profit foundation with a capital labeled 'surplus' or some similar name."

Our Opinion

We have been unable to find a discussion in the accounting literature of the first basic question raised in your letter, i.e., whether a *vested future interest* (as the property right of the foundation may be characterized in legal terms) is properly admissible within the family of assets, and, accordingly, should be reflected as an asset in the balance sheet proper. In our opinion, the property right in question, although not specifically mentioned, comes within the purview of the definitions of "asset" set forth at pp. 42-3 of Kohler's *A Dictionary for Accountants* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1957) and at p. 13 of *Accounting Terminology Bulletins No. 1* (AICPA, 1953). Apparently, the foundation's future interest in the property is not contingent (the life tenant's death being an event certain to occur) and represents a present fixed right of future enjoyment of the property itself. Also, the foundation's future interest in the property is presumably presently assignable for value. We believe these considerations are sufficient to give the future interest accounting status as an asset.

For its general relevance, see the discussion at pp. 26.22-6 of the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956). In connection with what has been said above, note the statement at the top of p. 26.26 that footnotes may be used "To indicate the existence of contingent income or remainder interests in other estates or trusts." In drawing our conclusion above as to asset status, we have assumed that the foundation has a *vested,* not a contingent, remainder.

If fund accounting is being used by the foundation, and it employs a caption such as "Endowment and Other Non-Expendable Funds," we would be inclined to include the item in question as an asset thereunder. Assuming a party other than the foundation to be the trustee, the property right in question may be described as "Property Held in Trust by Others." Other possible designations for the item might be "Remainderman Interest in Real Estate" or "Vested Remainder in Real Property."

A question arises as to the carrying value to be attributed to the item, i.e., whether use of current fair value at the date the trust became effective is proper here. In the case of a present gift of property, of course, it would be recorded at an expertly appraised value as of the date of the gift. One might reasonably contend that a balance sheet does not ordinarily purport to reflect current or immediately realizable values for certain types of assets, and that current fair value may be used at the outset here provided there is clear indication in a footnote that the foundation's right and title to the property is subject to a precedent life estate. The property could then be written down whenever there was evidence of a serious or permanent impairment of its value. Some accountants might deem the "present value" of the property (taking into consideration the life expectancy of the life tenant) to be a theoretically proper carrying value. Another alternative would be to reflect the property in the statement proper at a nominal value of $1 and describe the nature of the foundation's interest in the property in a footnote, also indicating therein the current fair value of the property.

We believe the corresponding credit is in the nature of "capital," not a liability. You ask what the "capital" of a non-profit foundation is usually called. *College and University Business Administration* (American Council on Education, Washington, D.C., 1952, vol. 1)

INQUIRY: **554**

contains some helpful definitions of terms. We urge you to note especially therein the definitions of "Balance of Funds," "Principal of Funds," and "Surplus." Note also the terminology used to describe the capital section of a charitable foundation at the bottom of pp. 26.24-5 in the *Accountants' Handbook* (*op. cit.*).

Also, as a possible aid in classifying the foundation's future interest in the real property, note the definitions in *College and University Business Administration* (*op. cit.*) of "Annuity Agreement," "Annuity Funds," "Endowment Funds," "Funds Functioning as Endowment," "Funds Held in Trust by Others," "Living Trust Agreements," "Non-Expendable Funds," and "Plant Funds." If the real property in question is income-producing property and is held by the foundation as trustee to pay over rents and profits to the life tenant, then there is a reasonable basis for designating the property as "Property held subject to living trust agreement," or the property may be regarded as being in the nature of an annuity fund receivable in the future.

We are not clear from your letter as to the nature of the agreement entered into with respect to the notes receivable. If the notes represent so-called "estate notes" there is authority to the effect that they should not be included as an asset. *College and University Business Administration* (*op. cit.*), in discussing "Assets of endowment funds," states on p. 42: "Pledges, subscriptions, subscription notes, and *estate notes* should not be included as assets. However, memorandum accounts should be maintained for these contingent assets." (*our emphasis*)

Depending on who is entitled to receive the principal and interest payments on the notes and the restrictions placed on the use of the proceeds, it would appear reasonable to us to record the notes at their estimated net realizable value, and if fund classifications are used, include them under a Current, Agency, Endowment, Annuity, or Plant Fund heading, as appropriate. We would reflect a liability only for that portion of the principal amount of the notes that is appropriated or earmarked for, or designated as being payable to, a grantee or other third party.

Incidentally, we note that the balance sheet of the Ford Foundation does not contain a multiple-fund classification such as would usually be found in the balance sheet of a college or university. See in particular the "Capital" section of this balance sheet (available in or from AICPA's library).

Inquiry 555

Non-profit organization — recording material, non-recurrent, and restricted bequest of stock

"Your advice is requested as to the proper financial presentation of the following item:

"Company A is a non-taxable religious corporation whose income is derived principally from donations. A bequest is received of X number of shares of General Motors stock in perpetuity, with the restriction that the stock may never be sold unless the proceeds are reinvested in other assets such as a prudent investor would purchase. Company A has received donations and bequests of stocks before, but in comparatively small amounts and with no such restrictions. It has been the practice to treat these smaller donations as income and record them as such at their fair market value at the date of receipt. However, the bequest referred to above was a large one and it would result in a distortion of income to record it as such. Furthermore, since only the dividends from the stock may be used to defray current expenditures, it would seem that the value of the stock should not be included in income. It would further appear that the value of this stock should not be included in net worth for the same reason.

"Company A keeps its books on the accrual basis much as an ordinary commercial organization, the chief differences being its non-taxable status, the origin of its income and the nature of its expenditures.

"Your suggestions as to the proper treatment of this item on both the income statement and the balance sheet would be greatly appreciated. We would also appreciate receiving information as to any technical treatises which have been published on accounting methods and procedures for organizations such as this."

Our Opinion

We believe that where a non-profit organization such as the one mentioned in your letter receives a donation or bequest, the principal amount of which is restricted as to use or disposition, such amount should be viewed as endowment and treated basically as a capital rather than a revenue transaction. Accordingly, we believe the General Motors stock should be recorded as a capital contribution at its fair market value at date of receipt, and be included in the net worth or capital section of the balance sheet. We believe date of receipt rather than date of legal entitlement to the bequest is a more meaningful valuation date to the accounting entity, despite the fact that it is on the accrual basis.

Although your client does not employ the conventional fiduciary or "funds" accounting approach, nevertheless, we feel the following excerpt from the section in the *Accountants' Handbook* (Ronald Press Co., N.Y., 1956, p. 26.24) dealing with charitable trusts or foundations is applicable to your client's situation:

> Gifts Received. The creator of the trust or others interested in its activities may make more or less regular *contributions of funds* to help cover the current operating expenses or to be used for current appropriations and grants. Such receipts of funds can be treated as the equivalent of additional income of the trust.
>
> Other gifts, irregular and sizable in amount, may be received as contributions to the principal of the trust. The funds may be available for the general purposes of the trust, or they may be restricted to certain specified purposes. The amounts of such gifts should be credited to appropriate capital or principal accounts.
>
> Still another type of gift, which is not so easily classified, is the sizable and irregular contribution which is to be used for some special project, possibly all within the current year. Since such contributions do not fall within any ordinary concept of "income," they can probably best be treated as contributions to the principal of the trust, the same as other special-purpose funds.

Inquiry **556**

Life membership payments received by non-profit organizations

"A question has arisen in connection with fund accounting on which I would appreciate any information that you have. It concerns the proper accounting practice for *life memberships in a non-profit organization.* Does correct accounting practice allow you to set up the life membership donations in a permanent endowment fund, the income of which is credited to current operations, or the alternative of amortizing the life membership donations over a period of years in relation to the ages of the donors?"

Our Opinion

Although we have perused some likely sources, we have been unable to find any discussion of the proper method of accounting for life memberships in a non-profit organization. However, it seems to us that where, in connection with the formation of a non-profit organization, so-called charter or life membership payments are received, it would be proper to credit such amounts to a permanent capital account and reflect same in the balance sheet as "Members' Equity" or "Capital Contributed by Founders." Once the organization commences operations, however, any subsequent payments received as consideration for life memberships may properly be set up as deferred credits to income and amortized over periods or a period of years related to the respective life expectancies or composite life expectancy of the life members making such payments.

For whatever relevance it may have, you may be interested in the following excerpt from G. L. Hull's chapter on "Clubs and Fraternal Bodies" (in J. K. Lasser's *Handbook of Accounting Methods,* D. Van Nostrand Co., Inc., N.Y., 1954, at p. 275), viz.:

> Membership or initiation fees may be accounted for either as income in the period received or as a direct credit to permanent net worth account (Initiation fees), distinct from the Earned Surplus Account.

Incidentally, we see no reason why a board of trustees or overseers could not, upon receipt of unrestricted funds contributed by founders or others, establish by resolution that such funds are to function as endowment, temporarily, or irrevocably. However, we believe proper procedure in such a case would be to reflect the contributed unrestricted funds in question as current or general fund revenue, and after determination of the excess of current fund revenues over costs and expenses, transfer or appropriate the amount covered by the resolution to an endowment fund.

INQUIRY: 556

Inquiry **557**

Establishing "residual values" for capitalized assets of non-profit organizations

"I am currently engaged in a special study regarding the establishment of residual values for capitalized assets owned by non-profit research organizations.

"I would appreciate your advising me as to source of information regarding treatment of this concept. I am specifically interested in:

1. Does this type of organization (non-profit as opposed to profit) generally establish residual values on capitalized assets?
2. The bases used for determining amounts of residual values established."

Our Opinion

Kohler's *A Dictionary for Accountants* (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1957, at p. 418) defines "residual cost (or value)" as follows:

> *residual cost (or value)*: Cost (of an asset) less any part of cost amortized or treated as an expense or loss; book value; residuary outlay; recoverable cost; distinguished from salvage, which implies that the usefulness or recoverability (other than from the sale of scrap) has been reduced to zero.

You will note that "residual cost (or value)" is equated with "book value" and "residuary outlay," and, accordingly, would be distinguished from so-called "sound value."

You ask whether non-profit organizations "generally establish residual values on capitalized assets." Possibly one way of restating one aspect of this question would be: to what extent do non-profit organizations generally use depreciation accounting? For indication as to the difficulty of answering the latter question categorically, see the index herein, under the heading "Depreciation Accounting: non-profit organizations."

The answer to your question in the particular case of a "non-profit research organization," would depend considerably on the purpose or motivation underlying your special study. The concept of "sound value" might be more relevant and useful if a sale of equipment or facilities were involved.

On the other hand, whether from a going-concern standpoint, a non-profit research organization should use depreciation accounting, might depend considerably on whether such organization followed a policy of billing for its work at cost and wished to take all cost factors into account to determine whether it was breaking even – also on whether the organization wishes to operate on a self-sustaining or partially self-sustaining basis as far as replacement of equipment and facilities is concerned or whether it intends to finance capital replacement or expansion from fund-raising campaigns.

If "residual cost" is equated with "Outlay less any outlay expiration," then, depending on the purpose of your special study, a question might arise as to whether equipment or facilities either donated or financed from donations should be included in the complement of capitalized assets for which residual values are being established.

The answer to your question "2" based on the above definition of "residual cost (or value)" as contrasted with "sound value," seems to be: historical cost of the various assets less cumulative depreciation thereon to date taking into consideration current indications of remaining useful lives. Possibly, the Internal Revenue Service's *Depreciation Guidelines and Rules – Rev. Proc. 62-21* might be a helpful guide to you in establishing useful lives or estimated remaining useful lives.

(Volume 3 contains Chapters 12 through 26 and the Index.)

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